2005 Annual Report

Issued January 2006

MISSION STATEMENT

Protecting Vermont's financial future, we strive to:

- **Be the best office of the treasury in the USA.**
- **Offer the best customer service possible.**
- **Do our part to make this office a great place to work.**
- **Give Vermont taxpayers an excellent value.**

State of Vermont

Office of the State Treasurer

109 State Street

Montpelier, Vermont

www.vermonttreasurer.gov

Jeb Spaulding

State Treasurer

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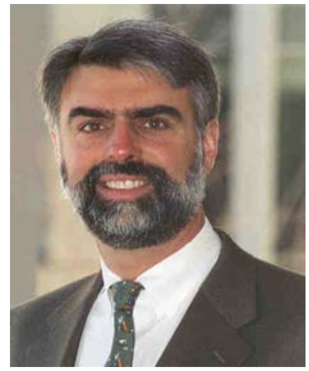


TO: Members of the General Assembly
Honorable James H. Douglas, Governor
Citizens of Vermont

It is my pleasure to present to you the 2005 Annual Report for the Office of the State Treasurer. I hope this document will offer an interesting and informative look at the Treasury, the services we provide, and the various reporting requirements of our office. As you review the accomplishments of our office over the past year and the financial results of our investment and capital financing efforts, you will note that 2005 was a busy and productive year.

The Office of the State Treasurer remains committed to maintaining Vermont's hard-earned reputation as a fiscally sound and disciplined state. Our efforts have borne substantial results – continued improvement in our debt profile, timely bank account reconciliation, a more efficient and effective investment process, a record amount of money returned to Vermonters through our unclaimed property program, strong investment performance, and a significant improvement in the technology through which we deliver services to our customers. We are proud to report to you some of the recent initiatives we have taken to improve the efficiency of our operations, protect consumer interests, encourage corporate responsibility, and invest in Vermont.

Many of the accomplishments discussed in this report were the result of collaborative efforts with various state agencies and departments, the Governor's Office, and the Legislature. We can *all* be proud of the efforts put forth to provide quality services to Vermonters in a cost-effective manner. We will face new challenges over the next several years, some of which are discussed below. Success in meeting those challenges will require the same collaborative effort that has served us so well to date. I stand ready to continue our partnership in tackling the financial issues facing Vermont.

<u>Pension Funding</u>

I would like to begin with one of the major challenges facing Vermont – the financial integrity of its pension systems. The Treasurer serves as the custodian of the State's three pension funds (state, teachers, and municipal). As part of my fiduciary capacity, I have consistently urged the adoption of funding levels that continue to protect the long-term viability of the pension funds for the benefit of current and future retirees, as well as for all Vermont taxpayers. While the State employees' and municipal systems are comparatively healthy, there is a serious level of underfunding associated with the Vermont State Teachers' Retirement System (VSTRS). Since becoming Treasurer in 2003, I have voiced my concern about persistent underfunding by the State of the VSTRS pension fund. Continued underfunding is not only shifting a funding obligation already incurred, at more expense, to future taxpayers, it may well in the future undermine benefits and the ability to recruit and retain teachers.

VSTRS is underfunded and has been increasingly so in recent years. Unfortunately, the actuarial method used by VSTRS under current law, which is rarely used by other public pension plans, tends to seriously understate the gravity of the situation. This methodology does not reflect underfunding in the "funded ratio" or "unfunded accrued liability," which are often used to measure and compare the financial health of pension plans. The actuarial method used by the vast majority of public pension funds shows that the VSTRS funded ratio declined from 92.3% in 2001 to 81.1% in 2005. At the same time, the VSTRS unfunded liability increased from $93.8 million in 2001 to $315.1 million in 2005. Unless the State changes course soon, Vermont may not be able to catch up with actuarially required contributions without taking draconian measures, and may jeopardize its favorable credit rating.

The 2005 General Assembly created the Commission on Funding the Vermont State Teachers' Retirement System (VSTRS) to make recommendations for funding an adequate, sustainable, and actuarially sound retirement benefit plan for Vermont teachers. I served as chair of this Commission. We completed our work in November and issued a series of recommendations to the Governor and the General Assembly. As noted in the report, if these recommendations are adopted and implemented together, the State would cut the difference between this year's appropriated amount and what is required for FY 2007 by more than 60%, from a difference of almost $35 million to less than $13 million.

In order to make the implementation of those recommendations useful for state policy, however, the State will need to faithfully appropriate the actuarially required amount each year going forward. If a long-term commitment to funding is not achieved, then the result may be viewed as little more than putting additional "debt" on the State's credit card, with no real plan to pay.

A copy of the report's executive summary is included in the appendices of this report. The full Commission report is available on the State Treasurer's Web site at www.vermonttreasurer.gov .

Another challenge will be the funding of post-employment benefits for VSTRS and the Vermont State Employees' Retirement System (VSERS). Recently adopted standards by the Governmental Accounting Standards Board (GASB 43 & 45) covering non-pension post-employment benefits, primarily health insurance, will have major financial and disclosure ramifications for the State of Vermont beginning in Fiscal Year 2008. For the first time, public sector entities will be expected to report the future costs of these benefits on their balance sheets. The Standards do not require pre-funding such benefits. However, the basis applied by the Standards for measurement of costs and liabilities for these benefits results in far larger yearly cost and liability accruals if they are funded on a pay-as-you-go basis, as they presently are in

Vermont and many other states, and not pre-funded in the same manner as traditional pension benefits.

A first look at this issue completed by Buck Consultants in 2004 for the Vermont State Teachers' Retirement System indicated that an annual contribution of approximately $41 million would be necessary in Fiscal Year 2005 to provide pre-funding for the future liability of VSTRS' retiree medical plans at a level that could be deemed adequate under terms of the new GASB standards. At that time we were paying roughly $10 million in health insurance premiums for this coverage. Therefore, the net increase in annual costs associated with pre-funding would be about $31 million. However, if we were to elect not to move toward full funding, the basis for the calculation of the new accounting expense that must be charged for VSTRS post-retirement medical benefits under the new standards would be far more conservative than it would be if a policy of pre-funding were adopted – significantly increasing the liability. The accrual of additional liabilities for these benefits required in the absence of pre-funding would be expected to add more than $1 billion in obligations to the State's balance sheet within a few short years of the effective date of the new Standards.

A similar analysis has been prepared for the Vermont State Employees' Retirement System; the net increase to provide pre-funding for the future liability of VSERS' retiree medical plans at a level that could be deemed adequate under terms of the new GASB standards in Fiscal Year 2005 would be close to $25 million.

As in the case of the VSTRS pension funding issue, addressing this requirement will require a joint effort among the Retirement Boards, the Legislature, the Treasurer, the Governor, and employee representatives. Though GASB 45 does not take effect until FY 2008, the issue is large and the time to develop a plan to meet it is now.

Vermont Pension Investment Committee

One of our most significant accomplishments this year was the implementation of a unified investment process for pension funds to achieve greater efficiencies and higher returns over time. This had been one of my highest priorities since shortly after taking office as the Treasurer in 2003. With the assistance of the Boards of Trustees of the three retirement systems, the Legislature, the Governor, the Vermont State Employees' Association, and the Vermont National Educational Association, this initiative was realized with the enactment of Act 50, which created the Vermont Pension Investment Committee (VPIC) on July 1, 2005.

As a result of the new legislation, investment decisions affecting all three systems are being made by the newly formed VPIC, a 17-member committee comprised of the Board members of each system. The primary objective of the VPIC is maximization of investment returns within acceptable levels of risk through a broadly diversified investment portfolio. The VPIC uses a unitized form of investment accounting that allows one pension fund's assets to be pooled with the assets from other pension funds for investment purposes, while maintaining a separate identity for actuarial, accounting, and asset allocation purposes. Each pension fund in a unitized system essentially owns shares in a pool.

Specific responsibilities of the VPIC include:

* Allocation of assets, subject to approval by the relevant retirement board;
* Selection and oversight of the pension consultant and custodian bank;
* Selection and oversight of investment managers;
* Establishment of appropriate investment policies and guidelines;
* Communication with the Treasurer's office regarding all matters relating to investment of Systems' assets.

The three existing retirement boards continue to oversee the operations of each system in such areas as actuarial valuation, medical disability, benefit revisions, contribution levels, and general administration, as specified in Vermont Statutes.

This unified structure offers significant advantages designed to improve the investment performance of the three systems, in addition to the attainment of lower investment manager fees. A single investment committee can more efficiently review investment options, including diverse asset classes and new investment managers, than three separate boards. This is expected to improve asset allocation decisions and lead to selection of best-in-class managers for the benefit of all three systems.

This initiative is expected to save approximately a million dollars in investment fees and costs on an annual basis. In addition, as a result of the new unified investment process, the Commission on Funding the Vermont State Teachers' Retirement System, after consultation with Vermont's actuary and pension investment consultant, recommends increasing the assumed rate of return for the VSTRS system by 25 basis points (.25%). This will have an immediate impact on the VSTRS funding problem noted above, reducing the actuarially recommended employer contribution by $6 million annually, based on the expectation of higher net investment return. Overall return across all three systems, consistent with the prevailing investment climate, should improve over time.

Investing in Vermont

In August 2004, our office initiated the *Treasurer's Bank in Vermont Program* in order to support community banking while earning a competitive return on State funds. The program is designed to be attractive to the wide range of banking institutions in Vermont, and is predicated on the belief that investing Vermont funds in Vermont, consistent with earning a competitive rate of return, is a good policy.

Historically, the State's short-term cash had been invested primarily out of state in government agency securities, high quality corporate commercial paper, and money market accounts at large financial institutions.

The new program began with a target allocation of $25 million. Due to success, both in terms of bank interest and high rates of return, we increased this allocation, first to $30 million and later to $40 million. At present, 17 Vermont banks are "prequalified" to participate in the program. Bids are accepted through the Internet on the first Wednesday of each month. The Treasurer's Office invests in bank CDs based on rank order of quoted bid rates and associated dollar levels until available funds for each scheduled bidding period are depleted. A block of funds is set aside for the scheduled bid in specified time frames. Some of the funds may be "short," generally thirty (30), sixty (60), ninety (90) and one hundred twenty (120)-day periods, while a portion is set aside for longer maturities, depending on the yield curve.

Since its inception, $133.4 million in Certificates of Deposit (CDs) has been awarded. As of December 31, 2005, $40 million is invested in certificates of deposit of varying maturities with rates well above comparable Treasury rates. This has been a win-win initiative for the Vermont Treasury and the banks. Considerable investment dollars stay in our home state and are available to promote community banking. At the same time, the State has earned extremely favorable rates. For complete information about the *Treasurer's Bank in Vermont Program*, go to www.vermonttreasurer.gov .

This program is just one example of our ongoing commitment to seek out investment opportunities that support Vermont community and economic development while earning an appropriate return. Other examples include investments by this office in the Vermont Community Loan Fund and the Vermont Development Credit Union totaling $200,000. The three investment firms used by the Treasurer's Office for a longer-term fund, referred to as the Trust Investment Account, are all based in Vermont. They are National Life Capital Management, Hanson Investment Management, and Prentiss Smith & Company. Chittenden Bank acts as the custodial bank. As of June 30, 2005, the fund had a principal balance of approximately $43.5 million.

Treasury direct investments through banks with branches in Vermont and investment managers based in Vermont total almost $84 million.

Investments

The State Treasurer's Office administers the investment policies and strategies adopted by the Vermont Pension Investment Committee for the assets of the Vermont State Employees' Retirement System, the State Teachers' Retirement System of Vermont, and the Vermont Municipal Employees' Retirement System. The three systems had combined assets of approximately $2.7 billion on June 30, 2005. Asset levels have continued to rise on a long-term trend consistent with national trends in pension portfolios.

In Fiscal Year 2005, one-year investment returns remained above the actuarial target (8 percent) for the three principal Vermont Retirement Systems: 9.7% for the Vermont State Teachers' Retirement System (VSTRS); 8.9% for the Vermont State Employees' Retirement System (VSERS); and 8.1% for the Vermont Municipal Employees' Retirement System (VMERS).

For the ten years ended June 30, 2005, the median public retirement plan in the United States had an average annualized total return of 9.0%, compared with

9.5% for VSERS, 9.9% for VSTRS, and 10.0% for VMERS. Vermont's retirement pension plans have outperformed and continue to outperform the majority of public pension plans over multi-year periods. As noted above, we expect an increase in returns, relative to the benchmarks, due to the new unified pension investment system.

The 2000 Legislature authorized the establishment of a trust investment account administered by the State Treasurer for purposes of investing restricted funds with non-expendable principal balances. As of June 30, 2005, the fund had a balance of approximately $43.5 million, of which $31.5 million was allocated to the Tobacco Trust Fund, $8.9 million to the Higher Education Endowment Trust Fund, and the remainder to various smaller trust funds. For FY'05, the fund had a total return of 10.2% versus the target return of 6.8%. For the same period, the S&P 500 Stock Index returned 6.3% and the Lehman Aggregate Bond Index returned 6.8%.

Unclaimed Property Initiatives

The primary function of the Unclaimed Property Division is to locate and return various forms of unclaimed financial property to the rightful owners or their heirs. This property could be forgotten bank accounts, uncashed pay checks, unclaimed security deposits, unused gift certificates, etc. It is most often in the form of money, but it can also be stocks, mutual funds, and contents of safe deposit boxes. The property comes from many sources including banks, credit unions, corporations, utilities, insurance agencies, retailers, and governmental agencies throughout the United States. The Vermont State Treasurer's Office acts as custodian to safeguard the assets until they can be claimed by the rightful owners or heirs.

In fiscal year 2005, the Treasury paid almost $6.5 million in claims to 7,828 claimants. This is a substantial increase over the previous four-year average of $1.88 million and is directly attributable to statutory changes recommended by my office and put into place over the past two years. One of these changes reduced the time period used to determine when property is defined as missing. Under prior law, most types of unclaimed property were forwarded to the Treasurer's Office after a five-year "dormancy" period. The revised statute reduced that holding period to three years, as is the case in many other states. I viewed this legislation as a consumer-oriented initiative because the longer we wait to begin looking for owners, the fewer people we find. People move and it becomes more difficult to find them. Since we collected a record $19.2 million of new money in 2004, our goal for 2005 was to reach out to our citizens over this fiscal year and assist them in filing claims for assets that rightfully belong to them. This proved to be a very effective approach, as evidenced by the numbers.

We continue to expand our outreach activities to reach more Vermonters. In addition to boosting our efforts to directly contact potential claimants, we advertise in daily newspapers, send listings to legislators, town clerks, and local libraries, host booths at various public events providing on-line access to our records, and use public service announcements to let people know we may have money for them. In October 2004, the Treasurer's Office made significant changes to its Web site to facilitate the claims process. Since then, there have been over 350,000 "hits" on the Unclaimed Property page.

During the next year we expect to focus on increased holder compliance to encourage holders that, to date, have not remitted property in compliance with the law. It is unfair both to the rightful owners and to the businesses that do comply when some entities do not remit these funds over to the Unclaimed Property Office.

Realizing that not all holders are aware of their responsibilities, we focused our compliance efforts on education. In May 2005 we conducted an educational session at the Annual Meeting of the Vermont CPA Society. The focus of the presentation was to make CPAs aware of their client company responsibilities relative to unclaimed property. We have met with other professional groups to make them aware of their responsibilities, and sent inquiries to a number of companies and entities. Currently we are working with several of them to achieve voluntary compliance. Over the next year, we will also be instituting an audit program to assure compliance.

This past year, I served as president of the National Association of Unclaimed Property Administrators. During this time we initiated a major initiative, *Operation Rightful Owner*, to recover and return matured unredeemed U.S. Savings Bonds to their rightful owners. Currently, the U.S. Treasury holds over $12 billion in unredeemed savings bonds that are no longer earning interest. A rough estimate for the amount owned by Vermonters is $25 million. State unclaimed property programs have the resources and networks to reach out to these bond holders and unite them with their funds. We are working with Congress on proposed federal legislation and pursuing a cooperative agreement between the states and the U.S. Department of the Treasury that would return the funds to the rightful owners and deliver post-owner-location proceeds to the protective custody of the state unclaimed property programs.

My office has reviewed the current unclaimed property statutes and, after meeting with a range of interested parties, has recommended broad changes to bring Vermont law up to date in conformity with industry practices and to assist us in becoming increasingly consumer-friendly. We look forward to discussing this draft legislation with the Legislature.

Retirement Operations and Technology Improvements

With approximately 42,000 active, inactive, terminated, vested, and/or retired members of the three state-level retirement systems, and a staff of only 12, our Retirement Division is a very busy office. The primary function of the staff is to serve the needs of the active contributing members and retired members receiving benefits payments. On the active member side, the Retirement Division oversees enrollments, transfers, refunds, and adjustments to members' accounts. On the retiree side, the Division oversees the issuance of the payroll, changes to dependents, adjustments to payments, and replacement checks. Other responsibilities include employee re-instatements, calculation of buybacks and refunds, disability retirements, and determination of survivor benefits.

Staff of the Retirement Division conducted 1,216 individual counseling sessions and processed a total of 716 retirements for members of the three systems during the 2005 calendar year – 365 Teacher retirees, 255 State retirees, and 96 retirees in the Municipal system. Staff also calculated over 7,000 retirement estimates at the request of prospective retirees, a 50% increase over 2004. A variety of staff conducted 75 informational sessions across Vermont for members of the three systems in 2005 for approximately 1,775 individuals. There is an extremely high volume of inquiries by phone, e-mail, and face-to-face appointments or walk-ins.

We will be challenged over the next several years to maintain a high level of quality services given the expected "bubble" in the retirement population. The "baby boomers" are reaching retirement age and Vermont, like other states, expects an increased demand for retirement services. According to a recent initiative sponsored by Governor Douglas, the Strategic Enterprise Initiative, 26% of executive branch employees will be retirement-eligible in five years and 43% in ten years. The key to meeting this demand will be through the development of increasingly more efficient operations that are supported with newer IT systems. The Retirement Division's technology infrastructure is, however, aging and barely able to meet current needs. The system was written between 1976 and 1980, after a design obtained from the State of Montana. The technology is severely outdated and prone to breakdown.

My office is implementing a multi-year retirement IT re-engineering project which began in 2003. We began with a review of current technologies and an assessment of our business processes. In 2004, the Retirement Division conducted a study of its operations and implemented a new organizational structure designed to streamline processes and improve customer service. This past year, we began the implementation of the technology phase with the conversion of approximately 1.8 million member documents (filling almost 80 filing cabinets) into electronic images and the implementation of an interim document management system. The acquisition of an automated pension solution for the management of the various retirement processes is now taking place. The system will be a stable, state-of-the-industry, fully integrated pension administration solution, including a tightly integrated imaging and electronic workflow capability. Web-enabled features will provide our customers far greater access to services.

To date, the project has met all its milestones on time, at or below budget. We will continue to work in partnership with the Department of Information and Innovation and our key business partners to bring this system on-line, phased in over the next three years. This initiative will assist us in continuing to deliver pensions, related benefits, and services that promote financial security for our customers, while meeting the growing demand in the most cost effective manner possible.

Investor and Corporate Responsibility

As fiduciaries for the State's pension funds and the common trust fund, the trustees of the Vermont retirement systems and the State Treasurer are required to act prudently and in the long-term economic interest of fund beneficiaries. The stocks purchased by investment managers for Vermont funds are assets carrying a voting responsibility that must be exercised with the same prudence. Shareholders are obligated to vote each year on certain significant issues that may affect the future financial performance of the company. In the past, proxy-voting responsibilities were delegated from the retirement systems and the Treasurer's Office to external investment managers with very little guidance. Research compiled by the Treasurer's Office has indicated that votes were often inconsistent and contradictory from one manager to the next, and often contradictory to Vermont policies and values.

Now, the three retirement boards and this office have a comprehensive common proxy voting policy statement and guidelines. The Policy's corporate governance guidelines include voting policies relating to boards of directors, auditors, shareholder rights, and executive and director compensation. The Policy's corporate responsibility and accountability guidelines include voting policies on environmental issues such as climate change and environmental reporting, as well as workplace issues such as equal employment opportunities, human rights, and labor codes. A copy of this Policy may be viewed on the Vermont Treasurer's Web site. All proxies are to be voted by a third-party proxy service provider in accordance with stated policy. In addition, a policy for international equity proxy voting will be developed allowing for the same service provider to vote international equity proxies as well. In 2005, the Treasurer's office also implemented procedures to begin voting proxies on unclaimed property assets in the custody of the Office.

This past September, along with the Sustainable Endowments Institute, I hosted a successful shareholder engagement workshop for Vermont colleges and universities to explain why it is important that they, as institutional investors, become involved owners, and how to do so, consistent with their fiduciary duties and educational missions.

I continue to work with the National Association of State Treasurers and others to support a number of corporate governance reforms. I am also a founding member of the Investor Network on Climate Risk and joined with eight other state and city treasurers and comptrollers to issue a 10-point "Call for Action" to the US financial community for increased disclosure and analysis of the risks posed by climate change to institutional and individual investors. I believe that over the long term, climate change and global warming pose significant dangers to investors and whole economies. As a trustee of Vermont's pension funds, which are long-term investments, and as a state official concerned with protecting Vermont's financial future, I am compelled to do my part to encourage companies to analyze and disclose potential risks and liabilities in this area.

Capital Financing and Debt

Vermont's debt profile continued to improve in Fiscal Year 2005.

Vermont enjoys the best bond rating of any New England State: AA+ or Aa1 by all three of the major rating agencies. We have achieved this through disciplined debt management and the steady goal of a balanced financial position with well funded reserves. One advantage Vermont receives from its favorable credit rating is lower interest rates when it borrows new money or refinances outstanding debt. In addition, other important entities such as the Vermont Municipal Bond Bank and the Vermont Housing Finance Agency benefit by the State's excellent ratings. My long-term goal is for Vermont to join nine other states in the country with triple-A ratings.

We have made steady progress in improving our debt indicators, a key component of achieving this goal. While the national trend has been to increase debt authorizations, the State of Vermont has reduced its total level of outstanding long-term debt over several years. The State's net tax-supported debt has fallen from $503.8 million in Fiscal Year 2000 to $440.3 million for Fiscal Year 2005. Our debt per capita and debt as a percentage of personal income, two key debt indicators, have been falling, while those of the triple-A rated states, on a composite basis, have been rising. In fact, Vermont's 2005 debt as a percent of personal income figure of 2.3% is better than the five-year average mean (2.6%) and median for triple-A rated states (2.4%). Moreover, considering the 2005 figures alone, Vermont's relative comparison improves even more, with a widening gap between Vermont's figure and those of the triple-A rated states (2.3 % vs. 2.7%).

In November, I orchestrated a meeting, along with Governor Douglas, Auditor Brock, David Coates, a long-term member of the Capital Debt Affordability Advisory Committee, along with our long-term financial advisor, Government Finance Associates Inc., with all three rating agencies (Fitch, Moody's Investors Service, and Standard & Poor's). We shared the State's long-term goals and objectives and also presented information concerning an upcoming bond issue. Shortly thereafter, Moody's took the action of revising the state's bond rating outlook from "stable" to "positive." This significant action, the first ratings move in recent years, reflects the hard work of Vermont governors, legislators, constitutional officers, and the many citizens who donate their time to improving the financial and economic health of Vermont. We hope that our continued improvement will eventually lead to the highest rating by all three agencies and concomitant savings for Vermonters.

In making their assessment, Moody's cited both the strengths and challenges associated with the Vermont financial and economic outlook. Credit strengths cited were:

- Sound financial management and fiscal policies indicated by conservative budgeting practices.
- Prompt action to reduce spending following revenue weakening during recession.
- Relatively rapid restoration of reserves used during period of revenue weakness.
- Steady progress in reducing previously high debt ratios.
- Low unemployment rates.

Credit Challenges cited by Moody's were:

- Medicaid cost pressures.
- Slower job recovery following rebound at the end of 2003.
- Achievement of timely financial audit reports with recently implemented system change.

The State has already made significant progress on the financial reporting issue. I want to commend both the Department of Finance and Management and the Office of the State Auditor for recent improvements in the issuance of financial report and audits. An unqualified audit opinion for the 2005 Vermont Comprehensive Annual Financial Report (CAFR) was achieved this past December. This is an important milestone for the State as a whole.

Vermont has worked hard in recent years to strengthen financial management practices and has demonstrated exceptional stability and discipline in debt, budget, and fiscal policies. As Vermont deals with new challenges, including pensions and the funding of post-employment benefits, I am hopeful we will bring the same discipline and foresight that has been used so successfully in the past.

I am proud of what my office has accomplished to date. I look forward to the challenges of 2006, and I am grateful for the opportunity to serve the citizens of Vermont.

Acknowledgements

I would like to sincerely thank all of the dedicated and hardworking members of the Treasury team for their support and commitment to serving Vermonters. I have enjoyed working with the Legislature and the Administration to protect Vermont's financial future and I look forward to working with both these entities in the coming year. My staff and I are available to discuss the information in this report, and welcome your inquiries and/or comments.

Sincerely,

Jeb Spaulding
State Treasurer

About the Vermont State Treasurer's Office

Responsibilities

The State Treasurer's Office is responsible for a wide range of administrative and service duties as prescribed by State statutes:

- Investment of State funds.
- Issuing of all state bonds authorized by the General Assembly.
- Serving as the central bank for State agencies.
- Management of the State's cash balances, processing of checks, and the reconciliation of payroll and vendor checks.
- Safeguarding and return of unclaimed or abandoned property, which is property being held in trust by the State until the rightful owner can be located.
- Administration of three major pension plans, the deferred compensation plan, and the defined contribution plan for State employees, teachers, and participating municipalities.

Our Commitment to Vermonters

The State Treasury manages money that belongs to all of the citizens of Vermont. The Treasurer and staff are committed to doing this honestly, efficiently, responsibly, and professionally. The Treasury operates as a business, serving the needs of Vermonters while working to save the taxpayers money and earn the highest possible return in its funds within acceptable risk parameters.

Protecting Vermont's financial future, we strive to be the best office of the treasury in the USA; offer the best customer service possible; do our part to make the Treasurer's office a great place to work; and give Vermont taxpayers an excellent value.

Administration and Organization

The Treasury is organized into an executive office and six divisions. The executive office is responsible for overall strategic planning, legislative initiatives, constituent relations, debt management, and supervision of the divisions.

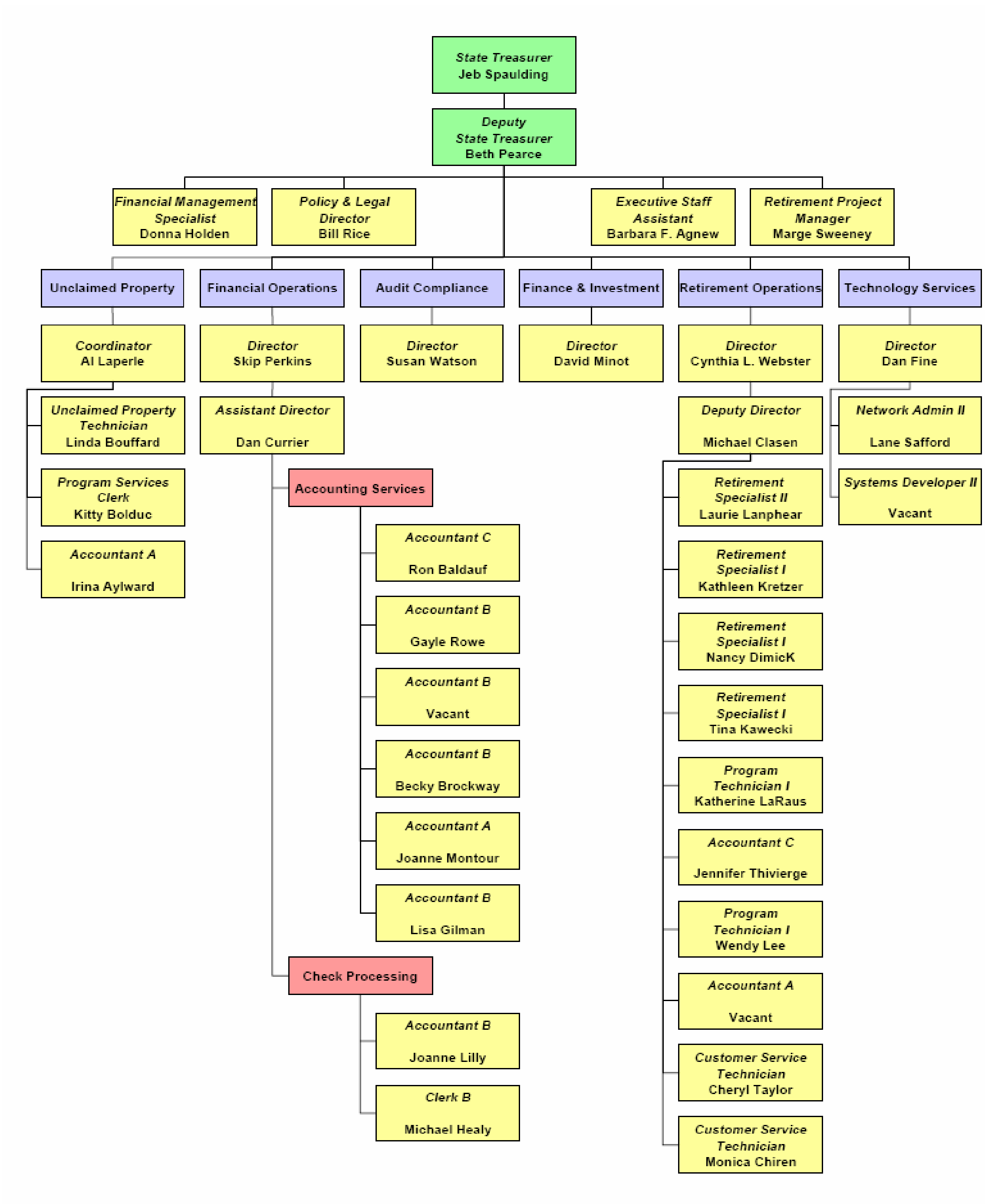
- Financial Operations is responsible for the State's banking, cash management, and financial transaction services.
- The Unclaimed Property division of the office serves as caretakers of abandoned or unclaimed property while seeking to return it to its proper owners.
- Finance and Investment Services provides cash, investment, and debt management for the State of Vermont and the three pension systems (State Employees, Teachers, and Municipal Employees) that are administered by the Treasurer's Office.
- Technology Services is responsible for developing and maintaining automated systems, providing appropriate access to information, maintaining the Treasurer's Office Web sites, maintaining the office network and its security, and providing automated interaction with other departments and entities outside state government.
- The Retirement Division administers the three public retirement systems authorized by the Legislature. They are for state employees, school teachers (grades K-12), and municipal employees. Approximately

Administration and Organization, continued

42,000 people are covered by these retirement systems.

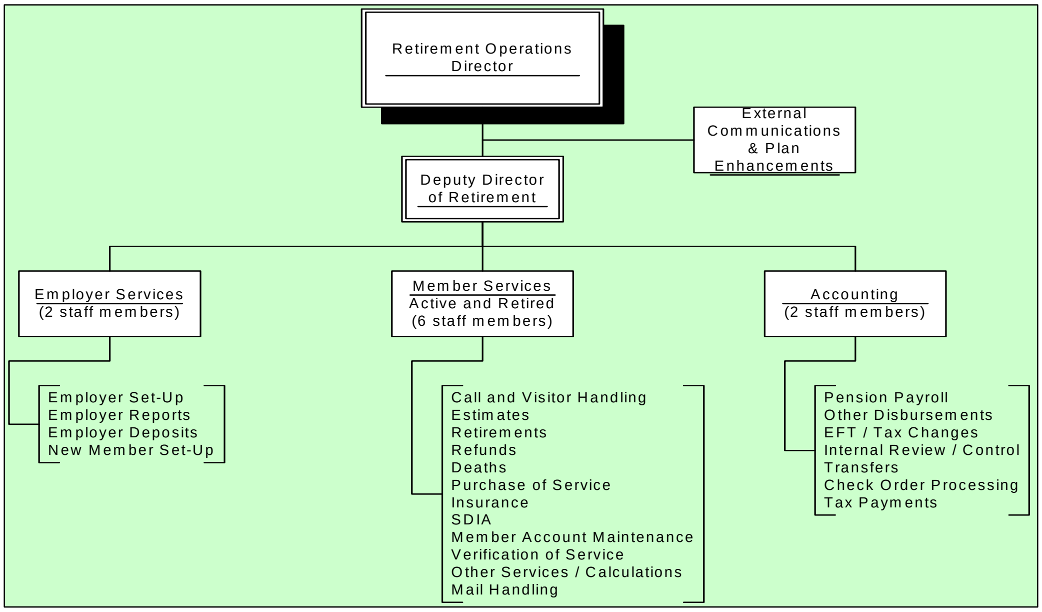
- The Audit Compliance Division was created in 1999 to conduct independent reviews of financial operations and controls within the State Treasurer's Office. The division determines whether acceptable policies and procedures are followed, established standards are met, and resources are used efficiently and economically.

Exhibit #1



The Treasurer's Office is always looking for ways to increase efficiency and utilize new and innovative business practices to improve service and make operations more cost-effective. Here is a sampling. Details are provided in this report.

Organizational and Operational Efficiencies.........



The Retirement Division completed a major re-alignment of its organizational structure over the past year. Integrating the concepts illustrated above, the Division created cross-functional teams according to the three key areas of a member's life-span: Employer Services, Member Services, and Benefits Delivery (Accounting). Key service and performance indicators have improved significantly.

Unclaimed Property Advertising

Faced with increased costs associated with statutorily required newspaper advertising, the Unclaimed Property Division developed a new computerized format, consolidated databases, and explored alternative delivery of information to newspapers. The result was a 70% decrease in advertising costs and improved outreach.

Single Deposit Investment Account Services

Services associated with the SDIA were consolidated in 2005 to provide improved customer services to our members and their beneficiaries. Improved services include 24-hour Web site access to account information, improved turn-around time for distribution requests, and access to customer service representatives, all at comparable costs.

Maximizing Financial Resources……….

Cash Management

- Through the use of improved cash forecasting techniques, we have reduced the costs associated with short-term borrowing.
- We manage over $4.0 billion in annual cash flows.

Debt Management

- Since January 2003, bond re-fundings initiated by the Treasurer's Office have generated $7,840,468 in future savings for taxpayers.
- Debt guidelines have been strengthened.
- Lower debt load has had a positive effect on long-term fixed costs of running government.

Investing in Vermont

- Investing approximately $84 million of short and long-term investments with Vermont institutions and investment managers.
- The investment performance of our pension funds consistently exceeds national averages, helping to support over $100 million a year in pension benefit payments and making a large contribution to our economy.

Retirement and Pensions

- We worked with the Legislature, Governor, Trustees, and unions to develop cost-effective proposals to improve the quality of our retirement plans.
- We identified long-term pension funding issues and provided proposed solutions.
- We implemented verification processes that ensure that the intended recipients are receiving benefits.

Efficiencies Through Technology..........................

New Web Entry System for Municipal Employers

An interactive Web entry system was deployed in September for the Vermont Municipal Employees' Retirement System (VMERS). Modeled after the highly successful Teachers' entry system deployed in 2004, it allows municipal payroll officers to submit their quarterly contributions reports online. Like its Teachers counterpart which was implemented last year, it is self-balancing and shows all bank remittances to date. This will reduce entry and reconciliation time.

Web-based technology has permitted the State Treasurer's Office to bring unclaimed property claim data right to potential claimants.

The Virtual Staple

The concept of a "virtual staple" for imaged documents was conceived and developed by State of Vermont Retirement staff in 2005 as part of the Vermont State Treasurer's Back File Conversion project.

In discussing operational needs of the Retirement Division, staff articulated the need to group or "staple" several imaged documents from an individual member file in order to complete a specific business process. For example, when a member retires, a number of different documents or images need to be reviewed to process the retirement and a number of different staff need to view these same documents. A "virtual staple" now enables staff to group documents together, thereby enabling other staff to readily view documents as a package rather than searching through all of the images for a particular member to find the relevant documents.

Document imaging improved office operations. Paper documents were boxed and shipped to archives. These were replaced with on-line digitalized records, improving access, streamlining workflow, and safeguarding important information.

Vermont Retirement Systems

The State Treasurer's Office administers three statutorily defined benefit pension plans with 24,637 active members, 6,013 inactive members, 1,763 terminated vested members, and 9,684 retired members as of June 30, 2005. These are the Vermont State Teachers' Retirement System (VSTRS), the Vermont State Employees' Retirement System (VSERS), and the Vermont Municipal Employees' Retirement System (VMERS). Both VSTRS and VSERS are funded by employee contributions as well as those made by the State. The Vermont Municipal Employees' Retirement System is employer/ employee funded, and does not have a state contribution.

In each case, a board of trustees is charged with the responsibility of general administration and proper operation of the retirement system. Day-to-day retirement operations are administered through the State Treasurer's Office based on policies and guidelines adopted by the boards of trustees. The State Treasurer is a member *ex officio* of each trustee board.

A number of issues were addressed by the retirement boards over the past year. The VMERS board saw the addition of ten new municipal entities over the past calendar year. The VSERS board implemented a new service delivery model for the single deposit investment account (SDIA) that enhanced services to its members. The VSTRS Board dealt with the complex issues of inadequate pension funding and related actuarial reporting. Both the VSTRS and the VSERS boards prepared for changes in Medicare funding as it related to health care benefits in the current year. Both boards will face an even more challenging issue with the treatment of

Vermont Municipal Employees' Retirement System Board (VMERS)

The board is comprised, by statute, of a representative designated by the Governor; the State Treasurer; and two municipal employees and one municipal official elected by the membership of the system. Left to right: Steve Jeffrey, Chair; Marie Duquette; W. John "Jack" Mitchell; David Lewis, Vice-Chair; and staff David Minot and Cynthia Webster.

Vermont Retirement Systems (continued)

post-employment benefits, primarily health insurance, as the state prepares to implement new GASB requirements in Fiscal Year 2008. The VMERS system is struggling with a different health care issue – the lack of any health care coverage for its members. Various proposals for limited health savings accounts were examined. In addition, all three boards dealt with the transition issues as investment functions were transitioned to the Vermont Pension Investment Committee (VPIC).

This year saw the first steps in the pooling of pension funds for investment purposes. Since taking office in 2003, our office has been pursuing a concept of unification, or pooling, of pension assets to achieve greater efficiencies and achieve a higher return. With the assistance of the Board of Trustees of the three systems, the Legislature, Governor, the Vermont State Employees' Association, and the Vermont National

Vermont State Employees' Retirement System Board (VSERS)

Name	Position
Warren Whitney	Chair, VSEA Representative
Robert Hooper	VSEA Representative
William Harkness	VSEA Representative
Joe Healy	RVSEA Representative
Jeb Spaulding	Vice Chair, State Treasurer
Linda McIntire	Commissioner of Human Resources
James Reardon	Comm. of Finance & Management
Richard Johannesen	Governor's Delegate
Tom Giffin	VSEA Alternate
Wayne Calderara	Retired Alternate

Left to Right: Above: Dick Johannesen discusses issues with NEPC investment consultants Joe Miletich and Kevin Kondry, Top Right: VSERS Chair Warren Whitney. Bottom right: members Joe Healy and Jim Reardon.

Vermont Retirement Systems (continued)

Left to right, standing: Vaughn Altemus, Jon Harris, Jeb Spaulding, Tom Candon, Cynthia Webster. Seated: Joe Mackey, Jay Kaplan.

Vermont State Teachers' Retirement System Board (VSTRS)

The board is comprised, by statute, of the Commissioner of Education, *ex officio*; the Commissioner of Banking, Insurance, Securities and Health Care Administration (BISHCA), *ex officio*; the State Treasurer, *ex officio*; two members of the system elected by members of the system; and one member elected by the board of directors of the Association of Retired Teachers of Vermont.

Educational Association, this initiative was realized with the enactment of the Vermont Pension Investment Committee on July 1, 2005.

In 2003, the Office of the Treasurer, working with the three retirement boards, developed a proposal to save approximately one million dollars per year in investment management fees for Vermont's three State-level pension funds, and to strengthen the investment oversight and management process of the three funds. This was completed based on a directive by the 2003 General Assembly to develop a proposal to pool the assets of State pension funds.

Unification is a form of investment accounting that allows one pension fund's assets to be pooled with the assets from other pension funds for investment purposes, while maintaining a separate identity for actuarial, accounting, and asset allocation purposes. Each pension fund in a unified system essentially owns shares in a pool. Investment growth and income are allocated to the individual funds based on the number of shares owned. Since investment management fees are based on the size of the portfolio under management, the consolidation of managers for investments in common asset classes will considerably reduce management fees. Under the proposal, the three existing retirement boards would continue to oversee areas such as actuarial valuation, benefits, and general

Vermont Retirement Systems (continued)

administration, but a new joint investment committee made up of board members and investment experts would be responsible for investment of the assets for each of the three Vermont Retirement Systems. In December 2003, all three retirement boards voted to support the proposal in concept. The 2004 General Assembly took up this issue but was unable to achieve a consensus with the various parties as to the make-up of the Investment Committee.

In the meantime, the Trustees took some voluntary steps to achieve some level of pooling where feasible resulting in partial savings. There was recognition, however, that the full impact could not be achieved without statutory changes. With a lot of hard work from all parties, agreement was achieved in the subsequent session.

As a result of legislation passed in FY 2005 and effective July 1, 2005, investment decisions affecting all three systems are made by the newly formed Vermont Pension Investment Committee (VPIC), a 17-member Board comprising the Board members of each system. The primary objective of the VPIC is maximization of investment returns within acceptable levels of risk through a broadly diversified investment portfolio. Specific responsibilities include:

- Allocation of assets, subject to approval by the relevant retirement board;
- Selection and oversight of pension consultant and custodian bank;
- Selection and oversight of investment managers;
- Establishment of appropriate investment policies and guidelines;
- Communication with the Treasurer's office regarding all matters relating to investment of Systems' assets.

The three existing retirement boards will continue to oversee the operations of each system in such areas as actuarial valuation, medical disability, benefit revisions, contribution levels, and general administration, as specified in Vermont Statutes.

This unitized structure offers significant advantages designed to improve the investment performance of the three systems. In addition to the attainment of lower fees, a single investment board may more efficiently review investment options, including diverse asset classes and new investment managers, than three separate boards. This is expected to improve asset allocation decisions and lead to selection of best-in-class managers for the benefit of all three systems.

VPIC met for the first time on July 9, 2005. Treasurer Spaulding was elected chair of the VPIC. Warren Whitney, chair of the VSERS Board, was elected vice-chair of VPIC. The VPIC has formed three subcommittees – an Executive Committee made up of three Trustee Board chairs and the VPIC chair, a Policy Committee, made up of two members of each Trustee Board, and the Investment/Search Committee, made up of two members of each Trustee Board.

The process of Board education has also been streamlined to benefit members of all three systems simultaneously. The VPIC now has the benefit of shared views and insights of members of all of the Retirement System Boards.

Vermont Retirement Systems (continued)

The three Vermont Retirement Systems have completed major transitions of assets held in their respective large cap domestic equity portfolios that involve common managers and increased use of enhanced indexing strategies. These changes are designed to produce superior rates of return within the asset class with less risk (volatility) and significantly reduced management fees.

Similarly, all three systems have transitioned their international equity and small cap equity portfolios to new managers common to all three systems. These managers have demonstrated superior investment performance in their respective asset categories. Additionally, two of the three systems have completed transitions to a common new Global Fixed Income manager, and the third system has committed to do the same.

Above: Treasurer Jeb Spaulding (Right), VPIC Chair, confers with member and VSTRS Chair, Joe Mackey.

Left Above: Warren Whitney, VSERS Chair, and Marie Duquette, VMERS member, review investment performance data at a VPIC Investment/Search Committee meeting.

Left: Jaye Johnson, of the Attorney General's Office and Bill Rice, Treasury Legal and Policy Director, offer investment manager contracting advice.

Retirement Division Operations

ACCOMPLISHMENTS IN 2005

- **The State Treasurer chaired the "Commission on Funding the Vermont State Teachers' Retirement System (VSTRS" Recommendations for funding an adequate, sustainable, and actuarially sound retirement benefit plan for Vermont teachers were submitted to the Governor and the General Assembly**

- **Staff of the Retirement Division conducted 1,216 individual counseling sessions and processed a total of 716 retirements for members of the three systems during the 2005 calendar year: 365 Teacher retirees, 255 State retirees, and 96 retirees in the Municipal system. Staff also calculated over 7,000 retirement estimates at the request of prospective retirees, a fifty percent increase over 2004. A variety of staff conducted 75 informational sessions across Vermont for members of the three systems in 2005 and approximately 1, 775 individuals were in attendance.**

- **As part of its technology initiatives, the Division completed an imaging project to scan and index 1,828,000 member documents that were filed in approximately 80 filing cabinets in the Retirement Office. Retirement staff now work with images on their desk-top computers via an internal web based system and we have both CD and microfilm back up of all images.**

- **This past year ten new entities joined the Municipal Employees' Retirement System.**

- **Administrative services associated with the Single Deposit Investment Account (SDIA) were consolidated to provide improved customer services to our members who hold SDIA accounts and their beneficiaries.**

- **The Retirement Division in collaboration with the IT Division successfully implemented a new Web-based system for reporting salary and contributions for all active municipal employees who are members of the Vermont Municipal Retirement System. This new system will provide greater efficiencies for the 412 reporting entities and the 5,800 active members of the system.**

- **An extensive RFP for a new pension administration system was released and proposals were reviewed. The Division is currently undergoing contract negotiations with the selected vendor.**

Retirement Division Operations

Overview

The State Treasurer's Office administers three statutorily defined benefit pension plans. Please refer to Charts #1 through #3 for comparative membership data on the three defined pension benefit plans.

In addition, the Office administers two defined contribution plans – a deferred compensation (457) program for state employees, and a single depository investment account (SDIA), a tax-sheltered account funded through employee transfers from a non-contributing system. Although Retirement contracts with third-party administrators to handle the investment options and day-to-day bookkeeping responsibilities for these plans, the office is responsible for providing new hires with information and comparisons of projected benefits, and also conducts one-on-one counseling to assist in the election process. Staff members process all transfers between the plans, and receive and transmit all contributions on behalf of the defined contribution members.

The Retirement Division is currently comprised of 12 staff members. The primary function of the staff is to serve the needs of the active contributing members and retired members receiving benefits payments. On the active member side, the Retirement Division oversees enrollments, transfers, refunds, and adjustments to members' accounts. On the retiree side, the Division oversees the issuance of the payroll, changes to dependents, adjustments to payments, and replacement checks. Other responsibilities include employee re-instatements, calculation of buybacks and refunds, disability retirements, and determination of survivor benefits.

Retirement specialists Nancy Dimick (seated) and Kathie Kretzer review a member's pension benefit estimate and supporting data.

There is an extremely high volume of inquiries by phone, e-mail, and face-to-face appointments or walk-ins. The retirement counselors provide one-on-one counseling and prepare estimates of pension and beneficiary payments for prospective retirees. Counselors and supervisory staff also conduct informational seminars throughout the state.

A breakdown of selected performance indicators for the Retirement Division is detailed in Chart #4. In addition, staff answered over 15,000 telephone inquiries from members of the three systems and responded to approximately 2,501 e-mail requests. Half of the telephone inquiries were from the Teachers' system, one-third were from the State system, and 17 percent were from the Municipal system. Staff also processed 823 purchases for service credit and acknowledged 90 Qualified Domestic Relations Orders.

Retirement Division Operations (continued)

Charts #1- #3

Vermont State Employees' Retirement System	June 30, 2005	June 30, 2004	Percent Change
Active Members			
Vested	5,479	5,321	2.97%
Not Vested	2,589	2,758	-6.13%
Total Active Members	8,068	8,079	-0.14%
Average Age	44.59	44.37	0.50%
Average Service	11.99	11.97	0.17%
Average Compensation	$ 43,289	$ 41,665	3.90%
Retired Members and Benficiaries			
Number	4,002	3,833	4.41%
Annual Retirement Allowances	$ 51,105,010	$ 45,977,080	11.15%
Inactive Members	1,104	968	14.05%
Terminated Vested Members	832	819	1.59%

State Teachers' Retirement System of Vermont	June 30, 2005	June 30, 2004	Percent Change
Active Members			
Vested	8,084	7,745	4.38%
Not Vested	2,660	2,570	3.50%
Total Active Members	10,744	10,315	4.16%
Average Age	44.55	45.92	-2.98%
Average Service	12.62	12.75	-1.02%
Average Compensation	$ 45,311	$ 43,967	3.06%
Retired Members and Benficiaries			
Number	4,592	4,386	4.70%
Annual Retirement Allowances	$ 60,545,793	$ 55,504,554	9.08%
Inactive Members	2,906	3,084	-5.77%
Terminated Vested Members	568	560	1.43%

Vermont Municipal Employees' Retirement System	June 30, 2005	June 30, 2004	Percent Change
Active Members			
Vested	2,833	2,590	9.38%
Not Vested	2,992	3,043	-1.68%
Total Active Members	5,825	5,633	3.41%
Average Age	46.50	46.31	0.41%
Average Service	6.40	6.16	3.90%
Average Compensation	$ 23,727	$ 22,356	6.13%
Retired Members and Benficiaries			
Number	1,090	1,099	-0.82%
Annual Retirement Allowances	$ 5,634,093	$ 5,592,873	0.74%
Inactive Members	2,003	2,438	-17.84%
Terminated Vested Members	363	210	72.86%

Retirement Division Operations (continued)

Chart #4
Retirement Division Performance Indicators

Activity	Calendar Year 2005	Calendar Year 2004	Percent Change
Estimates	7,031	4,700	50%
Individual Counseling Sessions	1,216	1,070	14%
Retirements	716	655	9%
Withdrawals	2,816	3,072	-8%
Seminars Held	53	57	-7%
Semiar Attendance	1,386	1,749	-21%
Payroll Officer Seminars Held	22	7	214%
Payroll Officers in Attendance	389	81	380%

Retirement Reengineering Project

The workload of retirement staff has increased steadily over the years, as retirement plans have become more complex and the number of members has increased. Over the next five years, the volume of retirements to be processed and client contacts is expected to continue to grow.

In an effort to better deal with higher case loads, to meet clients' needs in a timely fashion, and to improve customer service, an RFP was issued in October 2003 to obtain the services of a management consultant. The consultant made a number of recommendations for improving the productivity, cost-effectiveness, and internal control safeguards of the division.

The Division implemented many of the recommendations included in the consultant's report during 2004 and 2005. A new client-focused, service delivery model was adopted that organizes the staff into three key areas or units: employer services, member services, and accounting.

Previously, many Retirement Division processes were based on the specific retirement system being served at the time, and staff and associated tasks were divided along these lines as well. However, many of the day-to-day services and benefits provided by the three retirement systems use common processing methods. The model recommended by the consultant creates a more manageable and efficient structure that will also enable staff to improve accountability and customer service.

This increased accountability will be supported over time by the use of meaningful and focused performance measures. The model requires a minimum of two staff persons within each unit to ensure adequate coverage and to allow for cross-training that minimizes the risks when only one

Retirement Division Operations (continued)

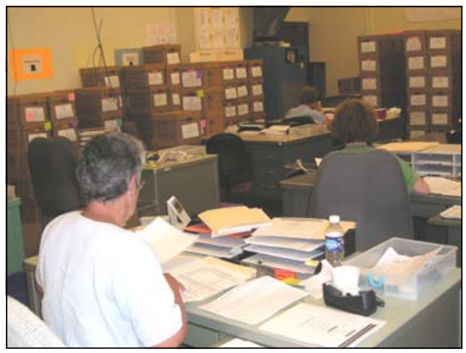
person knows how to complete specific tasks.

The Treasurer's Office also installed an automated telephone service to direct incoming calls to the appropriate division.

The management consultant also recommended that the Retirement Division begin the process of replacing its 25-year-old automated mainframe-based retirement system infrastructure with a modern and full-featured browser-based system. During FY 2005, the Retirement Division implemented a number of tasks to begin replacing the outdated computer system which will facilitate faster turn-around for inquiries and requested services, easier access to needed information and documents, increased accuracy of information, and timely identification of problems.

In January 2005, the Division obtained the services of a consultant company to provide retirement system expertise in the procurement of a retirement benefit administration and imaging system. A project manager dedicated to oversee and facilitate this effort was hired. It was decided that the procurement would be broken out into two stages. The first stage was to convert into electronic images the 1.8 million paper records that were stored in 80 filing cabinets. Since the Office of the State treasurer was scheduled to move to new space at the Pavilion building in October 2005, there was some urgency to complete this task prior to that date. This would eliminate the necessity of moving these records.

An extensive RFP was released on February 15th to convert the files, provide an interim imaging system, and produce microfilm and CD backup. Retirement's paper records were originals and were the only copy. This created significant risk should the files be lost or accidentally destroyed. Producing electronic images would enable the Division to comply with current public record retention requirements.



Staff prepare boxes of documents for imaging and then transport to Public Records

The conversion began on June 1st and all the images were available in the interim imaging system prior to our October move. The staff is currently using the interim imaging system to access images. This method has created efficiencies such as enabling staff to immediately access records from their workstation, has eliminated filing of member paperwork, and allows more than one staff member to view the records at the same time. These changes will be fully integrated with workflow functionality in the second project phase, creating even greater efficiencies. Electronic recognition of documents and routing /approval to the appropriate staff will be possible.

Retirement Division Operations (continued)

The second stage was to select a vendor to provide and implement a new pension administration system. A second RFP for a new pension administration system was released on July 12th. This comprehensive RFP detailed the procurement process and the project scope for a public retirement system implementation vendor to provide a comprehensive solution that included hardware, commodity software, pension administration software, project management, documentation, testing, implementation, integration, training, warranty, and support. A requirements traceability matrix with over 2,000 requirements was gleaned from the RFP and will be used during the project to track and verify that all requirements have been met. Proposals were due on September 14th and a thorough review followed which included client reference checks, product demonstrations, and numerous rounds of questions and answers.

In December, 2005, a vendor was selected and contract negotiations were concluded. An independent review required by statute of all large information technology projects was also conducted. (It is the responsibility of the CIO's office to conduct this review, totally independent from the Division.) The CIO's office hired an outside consultant who conducted a cost/benefit analysis, and documented that the project could be successfully completed, and identified any possible risks of it failing.

Contingent on the approval of the contract and the results of the independent review, a February 1st, 2006, project start date with a three-year phased implementation is planned. The Division wanted to avoid a "big bang" approach in which the entire solution is implemented in one phase. By delivering the solution in phases, the amount of change that must be absorbed at any one time can be reduced to more manageable levels. The major phases are anticipated to be hardware infrastructure and imaging installation, to be completed by fall of 2006; the membership functionality, to be rolled out in the summer of 2007; and the pension payroll , to be finished in the fall of 2008.

Project team members from left to right: Michael Clasen, Deputy Director of Retirement Operations, Dan Fine, Director of Information Technology, Marge Sweeney, Project Director, Rick Conklin, Project Management Director for DII, and Lane Safford, Network Administrator.

The Treasurer's Office wishes to thank the members of the Department of Information and Innovation for their assistance on this project.

Retirement Division Operations (continued)

Deferred Compensation Program

The Board of Trustees for the Vermont State Retirement System is responsible for a deferred compensation program that has been available since 1973 as a savings option for State employees, municipal employees, employees of agencies such as VSAC, VEDA, and VHFA, and members of the General Assembly. Because the deferred compensation plan qualifies as a Section 457 Plan under the Internal Revenue Code, the portion of salary that is deferred is not taxed at the time of deferral. On June 30, 2005, the plan had 5,436 State participants and 392 local participants for a total of 5,828 participants. Total assets in the plan were valued at $190.48 million. Participating employees made contributions in the amount of $17.27 million to the plan during FY'05.

Defined Contribution Plan

Established in 1999, the State's defined contribution plan had 591 participants and net assets of $32,630,082 as of June 30, 2005.

Under the defined contribution plan, which is modeled after private sector 401(k) plans, employees contribute 2.85% of their annual salary to their individual accounts. The State makes a fixed contribution of 7% to each employee's account. Employees are responsible for making all investment decisions among options selected by the Treasurer. At retirement or termination, employees receive the amount of contributions in their accounts, plus investment earnings. The defined contribution plan provides portability for an increasingly mobile workforce. It also reduces the unfunded liability for the State because the State does not assume the liability of a future pension benefit.

The Vermont Municipal Employees' Retirement System was given statutory authority in 1999 to approve a defined contribution plan for its members. The Board implemented a defined contribution plan on July 1, 2000. The plan provides the employer municipality with the first option of deciding whether or not to offer a defined contribution plan to its employees. Once a municipality elects to offer the plan to all eligible employees or to specific employment groups, an individual employee has the choice to remain with the defined benefit plan or transfer to the new defined contribution plan. New employees of municipalities offering both a defined contribution plan and a defined benefit plan have a choice of either plan. As of July 31, 2005, 94 municipalities had offered the plan, with 516 participants and net assets of $8,967,381.

Single Deposit Investment Account

The Single Deposit Investment Account (SDIA), a non-contributory defined contribution plan reported in the Pension Trust Funds, was established according to the provisions of Public Act 41 of the 1981 Session. The SDIA was intended to provide an investment vehicle in which to deposit contributions made by members of the

Retirement Division Operations (continued)

State and Teachers' contributory retirement systems who voluntarily elected to transfer to the newly established non-contributory retirement systems. Members electing to transfer to the non-contributory plans had their choice of one of the following three options:

- have both their accumulated employee contributions and accumulated interest returned to them; or
- have their accumulated contributions returned to them and only their accumulated interest invested in the SDIA; or
- have both their accumulated employee contributions and accumulated interest invested in the SDIA.

In addition to the initial deposits made into the SDIA in 1981, there were three subsequent opportunities, in 1984, 1987, and 1990, for contributory members to transfer to the non-contributory plans and invest their accumulated contributions and interest in the SDIA. No new monies have been invested in the SDIA since 1990.

The SDIA plan currently has approximately 2,729 members and beneficiaries and slightly over $100 million in assets.

Administrative services associated with the SDIA were consolidated in 2005 to provide improved customer services to our members who hold SDIA accounts and their beneficiaries. Following a competitive bidding process, Great West Retirement Services was selected to administer the day-to-day activities of the SDIA, including maintaining all demographic and beneficiary information, processing all requests for withdrawals and minimum distributions, and maintaining member account value information.

Expanded services for the SDIA that will now be available through Great West Retirement Services include 24-hour Web site access to account information, improved turn-around time for distribution requests, and access to customer service representatives through a local office in Montpelier and two account executives who travel throughout Vermont on a monthly basis.

Medicare Part D/Prescription Drug Subsidy

Under the Medicare, Prescription Drug, Improvement, and Modernization Act of 2003 (MMA), employer sponsors of retiree prescription drug plans can apply for a 28% subsidy for the qualified prescription drug costs of their retirees. To be eligible for the subsidy, the employer coverage must be actuarially equivalent to the new Medicare Part D coverage and the employer must provide notices of creditable prescription drug coverage to individuals entitled to coverage.

The State of Vermont Teachers' Retirement System Board of Trustees agreed that they would continue to offer the same prescription drug coverage program during 2006 that has been available to active and retired

Retirement Division Operations (continued)

teachers for the past several years. The Retirement Division has received an attestation from the actuarial firm of Buck Consultants that the prescription drug program offered to retired teachers is equivalent, and in fact, better than the drug program offered through Medicare Part D. Buck Consultants has also estimated that the annual 2006 subsidy amount will be around $1.2 – $1.3 million. We will request to receive this subsidy as a direct deposit into the Teachers' Retirement System on a monthly basis, which could begin as early as January of 2006. This money will act as a reimbursement for the projected $11 million that will be spent on retirees' medical premiums during FY 2006.

The State of Vermont has made a similar determination regarding the continuation of prescription coverage for retired state employees during 2006, and received the required attestation from an actuarial firm in order to apply for a subsidy. The actuary for the State has estimated that the annual 2006 subsidy attributable to retired state employees will be around $1.8 million.

The estimated FY 2006 subsidy is calculated based on the assumption that all of the retired employees currently carrying the prescription drug coverage will continue to do so, and as a result will <u>not sign up for Medicare Part D</u>. In essence, the subsidy is a rebate to plan sponsors to encourage them to continue to offer prescription drug coverage.

Most public sector retirement plans that offer prescription coverage to their retired population are electing to continue their coverage for at least 2006. By treating 2006 as a "transition year," systems will have time to analyze ways to control adverse selection in the future. Systems will also be able to evaluate the results of the first year of the Medicare Part D Program and its impact on the post-age-65 health care benefits marketplace and prescription drug pricing. The VSTRS and the State will need to determine in future years whether it is in their best interest to continue to offer the same prescription drug program, or whether it should be modified or discontinued. If the determination is to continue to offer the same coverage, the estimated annual subsidy will fluctuate depending on the number of retirees and covered dependents who actually sign up for the Medicare Part D Program. If it is determined that the prescription coverage should either be modified or discontinued, then the savings will be realized by a decrease in medical premiums.

<u>Pension Operations</u>

Employee and State contributions made to pension trust funds, in combination with investment returns, largely fund the operations of the retirement plans including benefits, insurance (teachers and state system), and administrative expenses. The results of operations for the three systems are reported in detail in Appendix A of this report. Chart #5, however, provides a synopsis of operations at a higher level. In Fiscal Years 2003 and 2004, the investment

Retirement Division Operations (continued)

Category	Vermont State Retirement Fund		State Teachers' Retirement Fund		Municipal Employees' Retirement Fund	
SOURCES OF FUNDS						
Employee Contributions	$	15,112,105	$	21,158,452	$	7,404,119
Employer Contributions		36,493,435		24,446,282		8,058,810
Other Income		777,792		373,705		298,475
Investment Income		90,452,723		115,058,694		18,165,861
APPLICATION OF FUNDS						
Retirement Benefits		48,893,673		60,147,731		6,418,097
Refunds		1,402,481		1,104,278		1,140,245
Health/Life Insurance Expenses		11,329,269		10,167,601		-
Administrative Expenses		1,255,852		1,052,772		367,810
Other Expenses		635,618		682,438		423,937
Addition to Net Assets Held in Trust for Pension Benefits	$	79,319,162	$	87,882,313	$	25,577,176

environment continued to improve and the three defined benefit plans experienced increases in net assets of $81,571,561 and $334,023,418 respectively. In Fiscal Year 2005, investment returns were again favorable, and an addition to assets totaling $192,778,651 was realized. Investment returns are the largest contributor to this increase, with gains of $223,667,278 in Fiscal Year 2005. In fact, over all, net assets (contributions minus pay-outs) would decline without investment returns. The VMERS system had a positive cash flow of $7.4 million excluding investment return and, not surprisingly, is the most actuarially sound of the three retirement systems. The VSERS fund had a net cash flow deficit of $11.1 million, when investment return was excluded. This is a relatively low percentage of its assets, .99%, again reflecting near full funding. The VSTRS system had a net cash flow deficit, excluding investment return, of $27.2 million. As a percentage of the total assets (2.04%), it is significantly higher than the VSTRS system, reflecting some level of imbalance. On an actuarial basis, the seriousness of the underfunding is even more apparent.

Retirement Division Operations (continued)

Pension Funding Concern: VSTRS Funding

As of June 30, 2005, the GASB 25 funded ratios, using the actuarial method prescribed by statute, for the three retirement systems were:

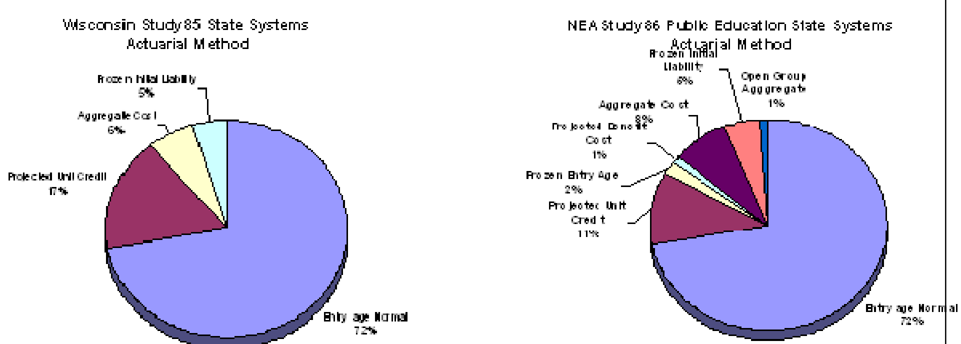
- Vermont Municipal Employees' Retirement System (VMERS), 104.4%
- Vermont State Employees' Retirement System (VSERS), 97.8%
- Vermont State Teachers' Retirement System (VSTRS), 90.7%

Relying on these ratios as an indicator of the financial health of these pension funds may lead to a false sense of security. In particular with the VSTRS, the actuarial methodology used does not accurately reflect the effect of annual under-funding.

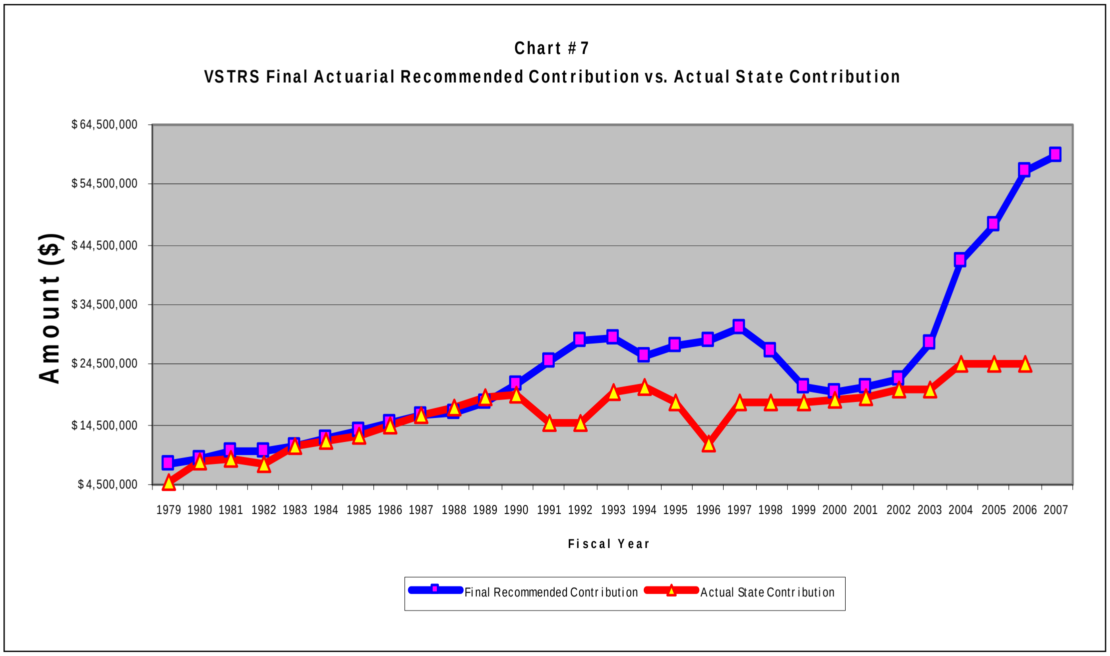
The Government Accounting Standards Board (GASB) outlines several accepted actuarial methods to measure funding. The State of Vermont uses the Frozen Initial Liability (FIL) method for its two largest systems, the VSTRS and VSERS. While this is an acceptable method, it is clearly outside of the norm. Two major studies on public retirement systems, the National Education Association's Characteristics of Large Public Education Pension Plans, published November 2004, and the Wisconsin Legislative Council's 2002 Comparative Study of Major Public Employee Retirement Systems, issued December 2004, both indicate that "Entry Age Normal" (EAN) is, by far, the predominant actuarial method used by public retirement systems (72% of all surveyed systems), while the "Frozen Initial Liability" (FIL) method was rarely used. The results are displayed in Chart #6 below.

The results of the FIL method, when applied to a system experiencing underfunding, can be misleading. VSTRS has, in fact, been substantially underfunded in recent years. Past history demonstrates a commitment by the State to fund the system at actuarially required levels until 1990, as can be seen in the chart #7.
Then, in fiscal years 1991 through 1998, state contributions paid into the

Chart #6
Comparative Studies on the Use of Various Actuarial Methods



Retirement Division Operations (continued)



VSTRS retirement plan were substantially less than actuarial requirements. The shortfall was reduced over the next several years, largely due to unprecedented investment returns that are not likely to be duplicated in the foreseeable future. Recently, the gap between actuarially required contributions and actual appropriations has grown dramatically to unprecedented levels.

Unfortunately, underfunding compounds. Underfunding in any single year means lost investment returns in future years, resulting in ever larger required contributions, which are becoming difficult to reach. According to a 2004 estimate provided by Buck, the system has "lost" approximately $120 million in interest earnings due to underfunding. That amount has, no doubt, continued to increase. It now becomes a State obligation. This cost will ultimately be passed on to future taxpayers and will require even greater contributions in future years to meet these obligations.

Using the FIL Method, the unfunded liability is calculated in a deterministic manner that does not reflect the actual experience of the plan and does not reflect underfunding. Under the FIL method, the impact of unfavorable experience and underfunding is absorbed in the calculation of "normal cost," a separate component of pension funding, and not in the unfunded liability. That is one reason why, while the funding ratio under the statutorily prescribed method improves, the total required contribution (which consists of the sum of the amortization of unfunded actuarial accrued liability and normal cost) is escalating rapidly. The unfunded liability of the VSTRS was established and frozen under the FIL method by statute in 1988. Again, under FIL, the ratio of the System's assets to accrued liability will rise from one year to the next, even in the presence of substantial underfunding and/or during a period of poor

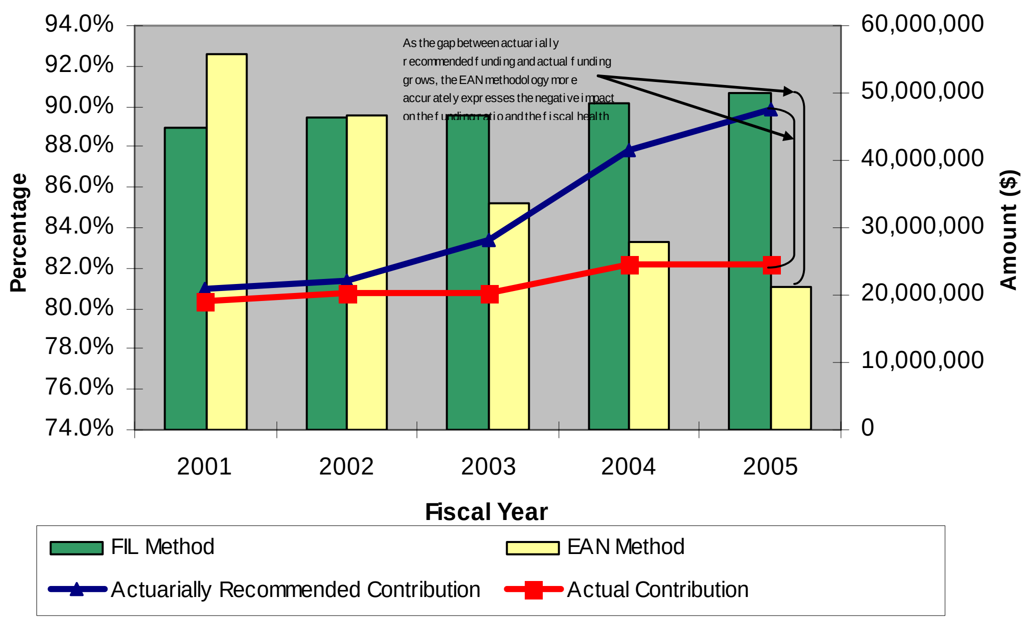
Retirement Division Operations (continued)

investment results. Any impact of underfunding subsequent to the "freezing" of the liability in 1988 falls to "normal cost," instead of being added to the unfunded liability, as in more conventional funding methods.

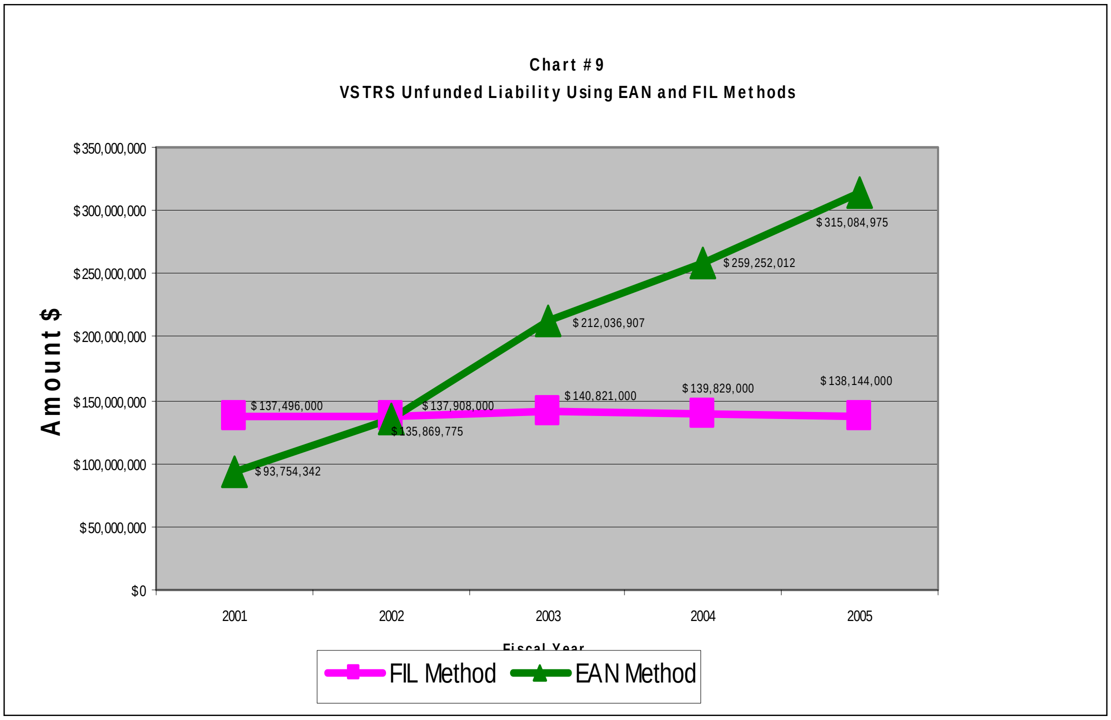
Since contributions to the VSERS system have generally been consistent with actuarial recommendations, the variance to the EAN method is not substantial. It is, however, a much different case for the VSTRS system. Buck Consultants was asked by the Treasurer, the VSTRS Board of Trustees and the Commission on Funding the Vermont State Teachers' Retirement System to re-compute the funding progress for the system from 2001 to 2004 comparing the current FIL method and the more accepted EAN method. The graph below (chart #8) demonstrates that the current method provides a false sense of security. Using the more accepted industry standard of actuarial methods, EAN, Vermont has actually lost considerable ground in the status of pension funding in recent years. Using the actuarial method used by most states, the VSTRS funded ratio declined from 92.3% in 2001 to 81.1% in 2005. In addition to resulting in a misunderstood funded ratio, the current FIL method is masking the real unfunded liability being accrued by Vermont, which has grown from $93.8 million in FY2001 to $315 million by June 30, 2005, as opposed to $138 million using the FIL method (Chart #9).

The 2005 General Assembly created the Commission on Funding the

Chart #8
GASB Funding Ratio and Contribution Levels for VSTRS



Retirement Division Operations (continued)



Vermont State Teachers' Retirement System (VSTRS) to make recommendations for funding an adequate, sustainable, and actuarially sound retirement benefit plan for Vermont teachers to the Governor and the General Assembly. The reason for the Commission is the fact that the VSTRS is underfunded and has been increasingly so for well over a decade. To address the serious resulting liability, the Commission made a group of recommendations to be implemented together. Based on its findings, the Commission recommended:

- Make no change in benefits at this time because current benefits are modest by comparison with similar plans and because any realistic changes to the benefit structure would not provide significant immediate savings.
- Adopt the Entry Age Normal (EAN) actuarial methodology because doing so provides a more accurate picture of the plan's funded status and is consistent with most public retirement plans.
- Re-amortize the unfunded actuarial liability (UAL) over 30 years because, while this will increase plan costs over that period, it will reduce the State's required annual contribution substantially.
- Increase the assumed rate of investment return by .25% because doing so reflects the beneficial effects of Vermont's new unified pension fund investment process.
- Create separate appropriations for normal and UAL costs because doing so will make plan costs associated with underfunding distinct from costs associated with paying benefits.

Retirement Division Operations (continued)

- Enact stronger statutory language to ensure that future appropriations match the actuarial recommendation.

- Fully fund both normal and UAL costs beginning in FY 2007 because doing so is necessary both to justify implementing other recommendations and to preserve the fiscal integrity of the VSTRS.

Using the current FIL method with current amortization schedules and actuarial assumptions, the recommended funding contribution for FY2007 is $59.2 million. The impact of changing to the EAN method, revising the investment rate of return, and restarting the amortization period brings the actuarially required contribution level to $38.2 million, a difference of $13.8 million when compared to the FY06 budgeted contribution of $24.4 million. Further, by applying the savings from the Medicare Part D program (previously described), the difference between the actuarially required contribution and the current budgeted contribution would be reduced to slightly less than $13 million. The Commission listed several recommendations for bridging that difference as well as several alternatives which, while they did not receive majority approval by the Commission, were presented in the Commission's final report. The Treasurer's Office urges the Legislature to consider all such alternatives, as well as any independently brought before the General Assembly. The real danger is to implement an amortization restart without having a plan in place to address the remaining $13 million. It is tantamount to putting debt on your credit card without a plan to pay for it.

As noted by the Commission, Vermont can not afford to continue to underfund the Vermont State Teachers' Retirement System. The tipping point where the State will not be able to catch up with actuarially required contributions without draconian measures is approaching rapidly. Pension benefits are essentially legally binding IOUs to employees that accumulate while they are working and that are cashed in at the time of retirement. Taxpayers and future teachers are at significant risk without restoration of funding at the actuarially required levels.

Despite enjoying strong economic growth and prosperity in recent years, the State has failed to meet its obligation to properly fund the system. Prudence dictates that it must restore funding in the current period of relatively positive financial results and economic prosperity. In addition, there will be greater financial pressures in the future. For example, new Government Accounting Standards Board requirements for disclosure of funding for other post employment benefits (OPEB), primarily health benefits, will create even more demands on scarce resources, not just for the VSTRS system but for VSERS as well. These issues are discussed below.

The executive summary of the Commission's findings and recommendations is included in the

Retirement Division Operations (continued)

appendices to this report.

Health Care and Other Post Employment Benefits (OPEBs)

VSERS and VSTRS, like many retirement systems, offer post-retirement health care benefits to their members. Like many other systems that provide these benefits, the practice has been to handle the obligation for these benefits on a "pay-as-you-go" basis and not to pre-fund them.

In 2004, the Governmental Accounting Standards Board (GASB) adopted two standards (GASB 43 and GASB 45) that will require governmental employers that sponsor such plans to account for health and other post-employment benefits on an accrual basis using actuarial standards. Implementation of these standards will be required in FY2008.

A normal cost and unfunded accrued liability will have to be measured for these benefits, in much the same way that they are already required to be measured for defined benefit pension benefits. An "annual required contribution" (ARC) will have to be calculated as the sum of normal cost and a provision for the amortization of the unfunded accrued liability. The assumed interest rate used to value future benefits will have to reflect the anticipated future rate of return assets earmarked to pay these benefits.

In 2004 Buck Consultants completed a preliminary study, based on 2004 data, for the VSTRS and VSERS systems. In the case of VSTRS, the study indicated that an annual required contribution (ARC) of approximately $41 million would be necessary in Fiscal Year 2005 to provide pre-funding for the future liability of VSTRS' retiree medical plans at a level that could be deemed adequate under terms of the new GASB standards. Since at that time we were paying roughly $10 million in health insurance premiums for this coverage, the net increase in annual costs associated with pre-funding would be about $31 million. In the case of VSERS, the ARC, measured in 2004, was approximately $38.6 million. Given a pay-as-you-go payment of $13.6 million, the net increased contribution would be about $25 million.

The GASB statements require the use of a very low interest rate in the calculation of the present value of the future benefits to be paid in cases where a government fails to pre-fund these benefits. This is based on the concept that pre-funding will permit governments to invest these funds in a manner similar to pension funds, while the lack of pre-funding means that the funds will be paid from operating cash which earns a lower rate of interest. This will result in much higher values for the ARC than would occur under the higher interest rates that apply if benefits are pre-funded. In the case of VSTRS, the annual contribution liability will increase from $41 million to $131 million. The VSERS annual contribution would increase to $97 million under the same scenario.

These are annual contributions. To the extent they are not funded, a liability would be posted to the financial statement, increasing by the level of

Retirement Division Operations (continued)

underfunding each successive year. This will have significant implications over time, as the rating agencies have clearly stated that a government's response to pension funding and OPEBs will be taken into account in developing assessments of the credit worthiness of the entity. If bond ratings are affected, the cost of bonding will likely increase.

"Pension funding is an important element of credit analysis because pension expense has a direct effect on current budgets and a long-term impact on overall financial flexibility. Contractually obligated pension expenditures, along with debt service commitments, are amongst a governmental entity's fixed-cost burden, pulling resources from other essential programs.... Fitch Ratings expects few, if any, downgrades to occur solely as a result of rising pension costs. <u>However, increasing pension expenses can contribute to or exacerbate declines in liquidity and financial flexibility that may lead to down-grades in the absence of corrective action</u>."

-Fitch Rating Service, 9/18/03

"State governments have a long history of providing retirement security for their employees – and in many cases certain local government em-ployees – through large, defined benefit pension systems, which, throughout the 20th century, had been successful in meeting their intended goals. However, after state pension funds reached their apex of financial soundness, based on funding levels, in 2000, they have since deteriorated – in many cases precipitously – leaving most funds with the problem of managing new, large unfunded liabilities. <u>The rapid growth and significant magnitude of these liabilities has become an increasing credit concern for many state ratings, reaching crisis proportions in some cases."</u>

- Standard & Poor's, 1/21/05

Debt Management

ACCOMPLISHMENTS IN 2005

- **Vermont maintains double-A plus bond ratings and continues to have the best rating of any New England state.**

- **The State Treasurer's Office issued $41.0 million aggregate principal amount of general obligation bonds in Fiscal Year 2005. This included a $26 million competitive offering in February with a true interest cost of 3.89% and average life of 13.4 years, followed by a $15 million negotiated "Citizens Bond" offering in March with a true interest cost of 3.65% and average life of 5.4 years. In May 2005, the State issued $20.8 million of General Obligation Debt Refunding Bonds to take advantage of low interest rates to retire higher-cost outstanding debt.**

- **The Capital Debt Affordability Advisory Committee (CDAAC) recommended maintaining the State's annual bonding level at $45 million in fiscal year 2007. While level with the FY 2006 authorization level, this amount is $6 million above the authorization level for FY 2004. Over a three-year period, the State has been able to raise an additional $14 million of funds for capital projects versus level authorizations of $39 million, the authorization amount for five of six years through 2004.**

Debt Management

Bond Issues

The State Treasurer's Office issued $41.0 million aggregate principal amount of general obligation bonds in Fiscal Year 2005. This included a $26 million competitive offering in February with a true interest cost of 3.89% and average life of 13.4 years followed by a $15 million negotiated "Citizens Bond" offering in March with a true interest cost of 3.65% and average life of 5.4 years. The Citizens Bonds, typically with shorter maturities more attractive to retail as opposed to institutional investors, are offered only to Vermont residents in denominations as low as $1,000 instead of the more traditional $5,000 denominations.

In May 2005 the State issued $20.8 million of General Obligation Debt Refunding Bonds to take advantage of low interest rates to retire higher cost outstanding debt. Approximately $8 million of that issue was also dedicated to the Vermont retail market.

Debt Management Approach

Historically, the State Treasurer's Office, in conjunction with the Administration and Legislature, has set a course of maintaining modest levels of new authorizations of long-term debt and net tax-supported debt outstanding. The State's debt issuance and management process has been characterized by a conservative approach designed to reduce the level and cost of debt. As a result, bond issuance is currently at substantially lower levels than in the early and mid-1990s. This factor plus continued improvement in the State's economic indices and financial condition over recent years have improved the State's debt ratios. The State's historical revenue surpluses resulted in full funding of the State's budgetary stabilization funds for the General, Transportation, and Education Funds over recent fiscal years, and contributed to significant pay-as-you-go amounts being employed for funding capital improvements. In addition, the State's practice of issuing debt with level annual principal installments has resulted in a favorable amortization rate. At approximately 80% within ten years, the State's bond payoff ratio has been favorably received by the rating agencies.

A major contributing factor to Vermont's respected debt management is the work of the Capital Debt Affordability Advisory Committee (CDAAC). The CDAAC completes an annual review of the size and affordability of the state tax-supported general obligation debt, and submits to the Governor and to the General Assembly an estimate of the maximum amount of new long-term general obligation debt that prudently may be authorized for the next fiscal year. The estimate of the committee is advisory, but historically has been adopted by the state as a bonding limit. CDAAC is made up of four *ex officio* members and one appointee of the governor. The State Treasurer serves as chair to the Committee. For fiscal years 2002 to 2004, CDAAC recommended a level of $39 million in new bonding each year. At its Fall 2003 meeting to consider the FY 2005 limit, the Committee recommended $41 million, encompassing a modest increase for inflation.

Over the last two years the Committee has revised its debt management

Debt Management (continued)

Chart# 10
Capital Debt Affordability Committee Target Guidelines

Debt Ratio	Guideline
Debt per capita	Moody's triple-A medians and means
Debt as Percent of Personal Income	Moody's triple-A medians and means
Debt Service to Revenues	Six Percent or Less

guidelines. Having met and exceeded the previously established guidelines, the Committee evaluated its current debt structure and capital financing goals. As a result, it adopted new guidelines consistent with Vermont's stated objective of achieving a triple-A rating from the bond agencies. A triple-A rating is an attractive goal for a state because it offers a lower cost of capital to the State and favorably impacts the ratings and costs of borrowing for State Agencies such as the Vermont Municipal Bond Bank, Vermont Housing Finance Authority, and Vermont.

Using these new guidelines (see Chart #10), the Committee met in September 2004. The Committee unanimously voted to recommend that the FY 2006 State General Obligation Debt bonding limit be set at $45 million, a 9.8% increase from FY 2005. In September of 2005, the Committee met to consider its bonding limit recommendation for Fiscal Year 2007. The Committee considered and balanced the objectives of meeting its credit rating targets and the need to finance needed State infrastructure projects. After considering authorization levels of $45 million to $51 million, the Committee unanimously voted to recommend remaining at the $45 million General Obligation Debt bonding limit. This level was the only amount in the range considered that would allow the State to achieve the goal of meeting all triple-A ratio guidelines by Fiscal Year 2009. Further, any higher levels would have the effect of increasing the State's net tax-supported debt outstanding (new debt would be greater than the amount to be retired). The Committee also observed that debt issuance moderation is appropriate in uncertain economic times. Finally, maintenance of a $45 million authorization level will mean that through Fiscal Year 2007 an additional $14 million of funds for capital projects will have been made available, versus the level funding at $39 million that had prevailed through Fiscal Year 2004.

Bond Authorizations

The State has maintained a fiscal discipline designed to reduce its overall debt levels. Bond issuance is currently at substantially lower levels than in the early and mid-1990s. This factor plus continued improvement in the State's economic indices and financial condition over recent years have brought down the State's debt

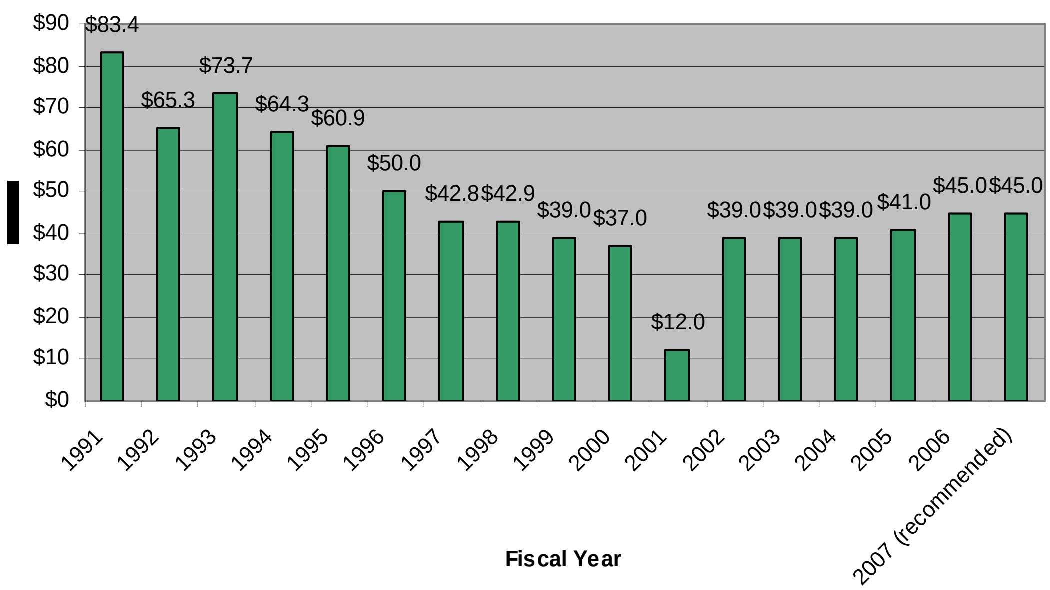
Debt Management (continued)

ratios. Chart #11 provides a historical look at bond authorizations. The State reduced its new authorizations for general obligation debt from $83.4 million in Fiscal Year 1991 to $39 million in Fiscal Year 2004. Revenue surpluses in fiscal years 2000 and 2001 resulted in full funding of statutory reserves and contributed to significant pay-as-you-go amounts being employed for funding capital improvements. While the capital needs financed in those two years were generally in the same range, cash reserves were used to finance these needs, rather than using the proceeds of bonds. Approximately $2 million of revenues was used to pay for capital projects authorized in Fiscal Year 2000. Approximately $22 million of revenues was used to pay for capital projects authorized in Fiscal year 2001.

While adoption of $41 million and $45 million annual debt authorization levels for fiscal years 2005 and 2006 represents modest increases, these levels and the planned maintenance of the $45 million level for Fiscal Year 2007 allow for continued reductions in outstanding debt.

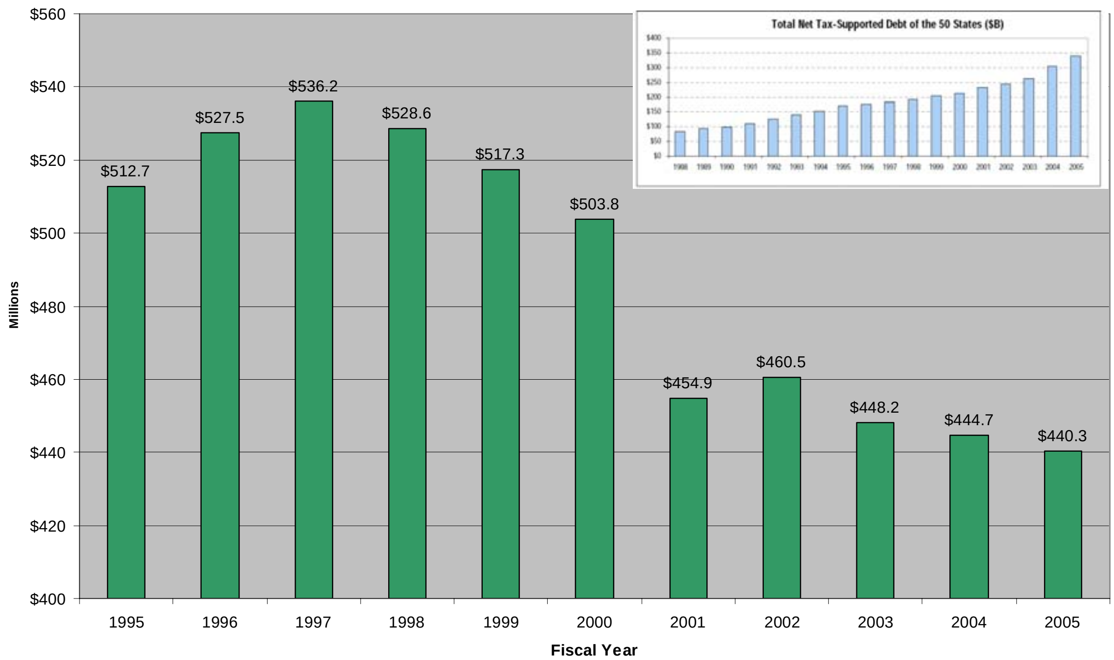
By keeping new authorizations at moderate levels, the State of Vermont has reduced its total level of outstanding long-term debt (Chart #12). Net tax-supported debt outstanding reached a high of $536.2 million in 1997 and had been above the $500 million mark until fiscal year 2001. For June 30, 2005, net tax-supported debt outstanding was reduced to $440.3 million. This is even more significant given that the national trend, in aggregate for all fifty states,

Chart #11
State of Vermont
Long-Term Debt Authorizations, FY1991 - FY2007



Debt Management (continued)

Chart #12
State of Vermont
Net Tax Supported Debt Outstanding, FY 1995 - FY 2005



has been to increase debt levels during this same period (see chart insert). Assuming continued authorizations at the current debt levels recommended by CDAAC, outstanding debt is expected to continue to decline. Using the current CDAAC model and continuing with the $45 million authorization level, outstanding debt would approximate $432.7 million by Fiscal Year 2016.

Total debt service, i.e., the amount appropriated to pay principal and interest on bonds, is calculated at $67.2 million for fiscal year 2006, versus $67.5 million in 2005. Future debt service payments will continue to fluctuate over the next decade and are not expected to show any multi-year decrease until fiscal year 2011, based on the current CDAAC model.

Bond Rating

Vermont continues to enjoy the highest composite bond rating in New England (Chart #13) and has avoided the downgrades experienced by some states within the past three years.

Because a higher rating enhances the State's reputation in the municipal marketplace, it makes the bonds more attractive in the marketplace. As noted previously, this generally results in a lower interest rate or cost of capital for borrowing. It is also likely to reduce borrowing costs for municipalities that issue debt through the Vermont Municipal Bond Bank or other borrowers issuing through other State Agencies, as the state's rating is applied to these bond issues. A high credit rating is also attractive to business development as it is a sign of economic and fiscal stability.

Debt Management (continued)

Chart #13

New England General Obligation Bond Ratings

State	Fitch	Moody's	S&P
Connecticut	AA	Aa3	AA
Maine	AA	Aa3	AA-
Massachusetts	AA	Aa2	AA
New Hampshire	AA	Aa2	AA
Rhode Island	AA	Aa3	AA
Vermont	**AA+**	**Aa1**	**AA+**

Debt Ratios

The fiscal discipline of the last several years is paying off as Vermont's debt ratios now compare favorably with triple-A states. This discipline, combined with the State's improving economic trends and financial reporting, provides a case for future bond upgrades. The key will be to demonstrate continued diligence in these areas while making improvements on other major sustainability issues – Medicaid funding, VSTRS funding, and the funding of post-employment benefits (OPEB). Summarized below are some of the key debt indicators for Vermont.

Debt Per Capita

One of the key debt factors monitored by the CDAAC and the rating agencies is the ratio of the State's net tax-supported debt per capita. The guideline adopted by the CDAAC establishes a target ratio of debt per capita at Moody's median and means for triple-A rated states. In 2005, the State's Debt per capita was $716 versus the Moody's triple-A median and mean of $682 and $831, respectively (Charts #14 and #15). The State's ranking versus all fifty states improved from 24th in 2004 to 25th in 2005. The higher the ranking figure, the lower a state's debt per capita is relative to all other states. While this represents an improvement, approximately one-half of all States have a higher (more favorable) ranking figure.

Currently, the State's debt per capita is $709. Assuming a steady level of debt authorization and issuance of $45 million in future years, and employing the population forecast developed by Economic Policy Resources, the State's net tax-supported debt per capita is forecast to decrease each year through 2014.

Debt as a Percentage of Personal Income

An even more important credit factor for assessing a state's relative ability to pay its general obligation debt is the ratio of net tax-supported debt as a percent of personal income. The new guideline adopted for this ratio is again to target Moody's median and mean for triple-A rated states. The State has steadily improved in this area, and the State's ratio of debt to personal income for FY'05 dropped to 2.3% versus Moody's triple-A median and mean ratios of 2.5% and 2.7%, respectively. The State's ranking in its debt as a percentage of personal income improved from the 25th

Debt Management (continued)

highest among the states in 2004 to 27th highest in 2005.

Debt Service as a Percentage of Revenue

The new guideline used for this ratio states that projected annual State debt service on bonds should not be in excess of six percent of projected revenues in the combined General and Transportation Funds. The debt service as a percentage of revenues ratio was 5.4% for fiscal year 2005. This percentage is expected to be below 6% through 2016, assuming the issuance of $45 million of debt from FY 2006 through FY 2016.

Chart #14
Net Tax-Supported Debt Per Capita

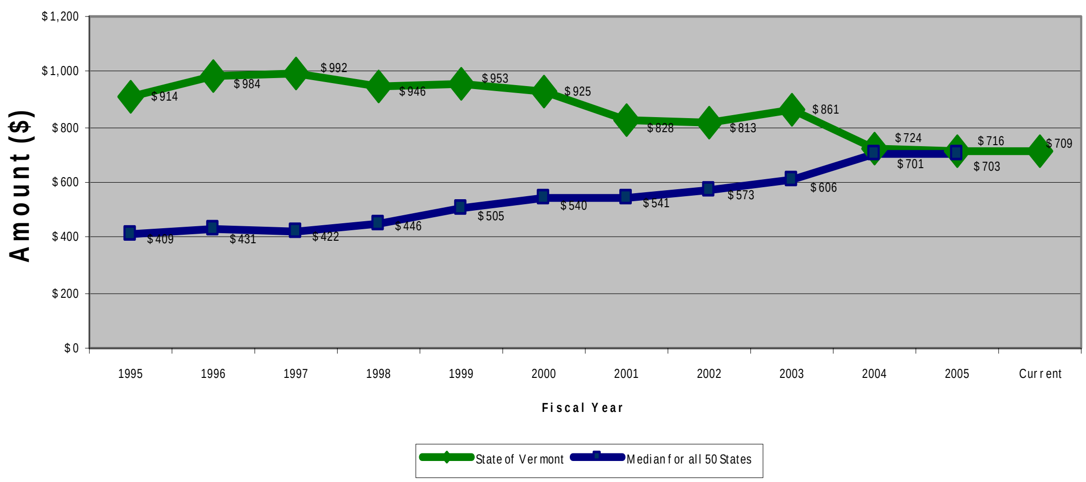


Chart #15

DEBT PER CAPITA

Triple-A Rated States	2001	2002	2003	2004	2005
Delaware	$1,616	$1,650	$1,599	$1,800	$1,865
Georgia	679	804	802	827	803
Maryland	819	879	977	1,077	1,064
Minnesota	546	576	625	691	679
Missouri	288	347	368	461	449
North Carolina	340	375	429	556	682
South Carolina	398	615	587	599	558
Utah	634	708	682	846	792
Virginia	537	566	546	546	589
MEAN	**651**	**724**	**735**	**823**	**831**
MEDIAN	**546**	**615**	**625**	**691**	**682**
Vermont	828	813	861	724	716

Triple-A Rated States
5-Year Averages:
MEAN: triple-A states: $753; Vermont: $788
MEDIAN: triple-A states: $625; Vermont: $813

Debt Management (continued)

Chart #16
Net Tax-Supported Debt as a Percent of Personal Income

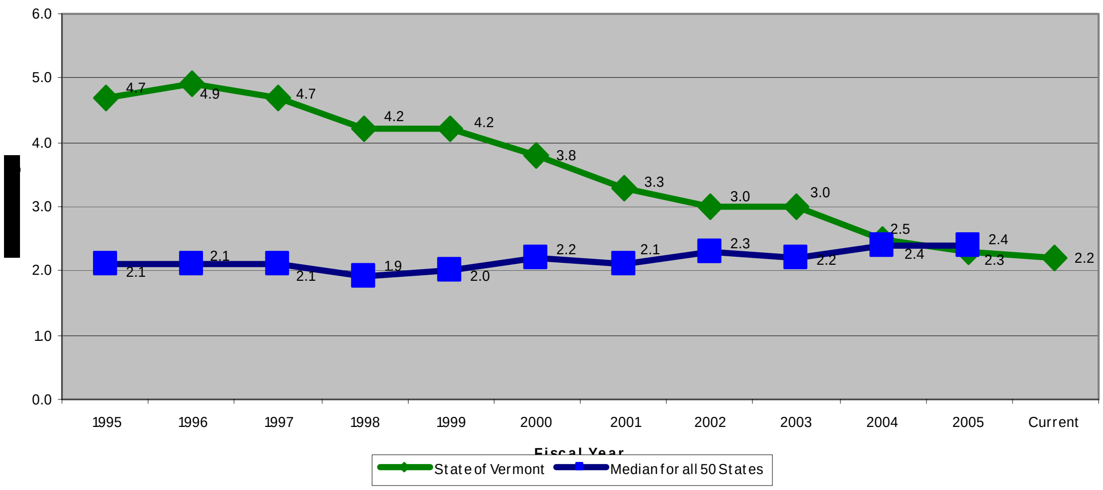


Chart #17
DEBT AS % OF PERSONAL INCOME

Triple-A Rated States	2001	2002	2003	2004	2005
Delaware	5.5%	5.3%	5.0%	5.6%	5.5%
Georgia	2.6	2.9	2.9	2.9	2.8
Maryland	2.6	2.6	2.8	3.0	2.9
Minnesota	1.8	1.8	1.9	2.0	2.0
Missouri	1.1	1.3	1.3	1.6	1.5
North Carolina	1.4	1.4	1.6	2.0	2.5
South Carolina	1.8	2.5	2.4	2.4	2.2
Utah	2.8	3.0	2.9	3.5	3.2
Virginia	1.9	1.8	1.7	1.7	1.8
MEAN	**2.4**	**2.5**	**2.5**	**2.7**	**2.7**
MEDIAN	**1.9**	**2.5**	**2.4**	**2.4**	**2.5**
Vermont	3.3	3.0	3.0	2.5	2.3

<u>Triple-A Rated States</u>

5-Year Averages:

MEAN: triple-A states: 2.6%*; Vermont: 2.8%

MEDIAN: triple-A states: 2.4%; Vermont: 3.0%

Debt Management (continued)

Short –Term Borrowing

In the early 1990s, Vermont was issuing approximately $150 million of short-term debt obligations annually, not including $65 million in deficit notes. The State's strong cash position did not require the issuance of short-term debt in fiscal years 1999-2002 (Chart #18). As the national and regional economy placed additional stresses on governmental revenues, the State's cash position in fiscal year 2003 did necessitate the borrowing of $75 million. The State issued $75 million in revenue anticipation notes (RANs) that matured on June 17, 2003. The notes bore a coupon rate of 2.5%, and interest on the notes was $1.5 million.

The State's cash position did, however, rebound quickly. In fiscal year 2004, short-term cash shortages necessitated the borrowing of $48 million in revenue anticipation notes, on September 6, 2003. These matured on March 6, 2004, and carried a coupon interest rate of 1.18%. Due to the low dollar amount and interest rate, combined with a relatively short borrowing period, interest on the notes was $283.3 thousand (Chart #19).

The period of cash need was considerably reduced over prior years, permitting full repayment in March. Typically, education payments to local towns and school districts occur in September and December, while tax revenues are collected later in the year, primarily April. By April 2004, the revenue flow was positive, and the State ended the year with a net increase in its cash position. Vermont began fiscal year 2004 with approximately $115.7 million in unrestricted cash and investments on hand and the year with more than $222.3 million in unrestricted cash and investments. The State's unrestricted cash and investment balance at fiscal 2005 year end remained healthy at $220.0 million. While this cash balance does not bear a direct one-to-one relationship to fund balance, it indicated a very healthy position.

The State's annual cash flow, despite some systemic seasonal fluctuation, is expected to remain healthy. As reserves have been replenished, the need for seasonal short-term borrowing is reduced. Over the past two years, the Treasurer's Office has implemented new cash projection forecasting techniques. This has permitted us to be more proactive in anticipating needs and, working with the State's bank of record, to set up a line of credit, rather than utilizing more expensive and less flexible vehicles such as RANs.

No short-term borrowing was required during fiscal year 2005, and short–term borrowing in FY 2006, if any, is expected to be accommodated by a modest bank line of credit.

The rating agencies have cited the reduction in short-term borrowing as a significant factor in their upgrades of the State's ratings. In addition, the State has saved significant money by reducing interest costs.

Debt Management (continued)

Chart #18
Short-Term Borrowing
Fiscal Year 1993 - 2006

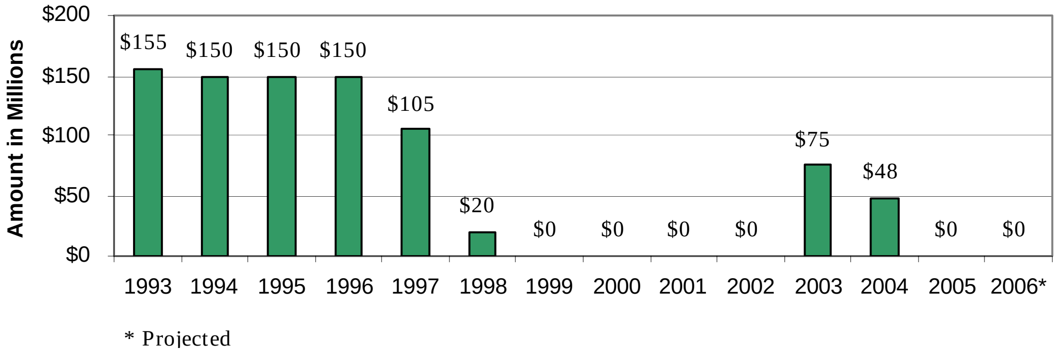
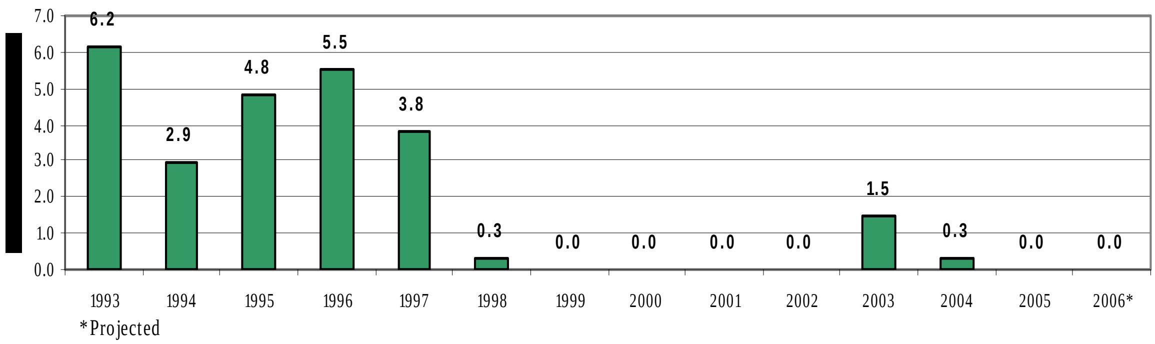


Chart #19
Interest Paid on Short-Term Borrowing
Fiscal Year 1993- 2006



Investments

ACCOMPLISHMENTS IN 2005

- **The Treasurer's Office led an initiative to unify the investment process for the Vermont State Teachers', Vermont State Employees', and Vermont Municipal Employees' Retirement Systems. As a result of legislation passed in FY 2005 and effective July 1, 2005, investment decisions affecting all three systems are now made by the newly formed Vermont Pension Investment Committee (VPIC), a 17-member Board comprising the Board members of each system. This new unified investment process is designed to improve the investment performance and lower investment costs for the three systems.**

- **The Vermont Retirement Systems have completed major transitions of assets held in their respective large cap domestic equity portfolios that involve common managers and increased use of enhanced indexing strategies. These changes are designed to produce superior rates of return within the asset class with less risk (volatility) and significantly reduced management fees.**

- **The Vermont Retirement Systems have transitioned their international equity and small cap equity portfolios to new managers common to all three systems. These managers have demonstrated superior investment performance in their respective asset categories. Additionally, two of the three systems have completed transitions to a common new Global Fixed Income manager, and the third system has committed to do the same.**

- **The Treasurer's *Bank in Vermont Program* is part of an ongoing effort by the State Treasurer's Office to support Vermont-based financial institutions when acceptable rates of return can be achieved. As of December 31, 2005, $40 million was invested with banks with branches in Vermont.**

Investments

Pension Fund Investments

The State Treasurer's Office administers the investment policies and strategies adopted by the Boards of the Vermont State Employees' Retirement System, the State Teachers' Retirement System of Vermont, and the Vermont Municipal Employees' Retirement System. The three systems had combined assets of approximately $2.71 billion on June 30, 2005. Asset levels have continued to rise on a long-term trend consistent with national trends in pension portfolios. The growth in assets is displayed in Chart #20 below.

In Fiscal Year 2005, one-year investment returns remained above the actuarial target (8 percent) for the three principal Vermont Retirement Systems: 9.7% for the Vermont State Teachers' Retirement System (VSTRS), 8.9% for the Vermont State Employees' Retirement System (VSERS), and 8.1% for the Vermont Municipal Employees' Retirement System (VMERS) (Chart #21). Asset levels also increased, as investment return is

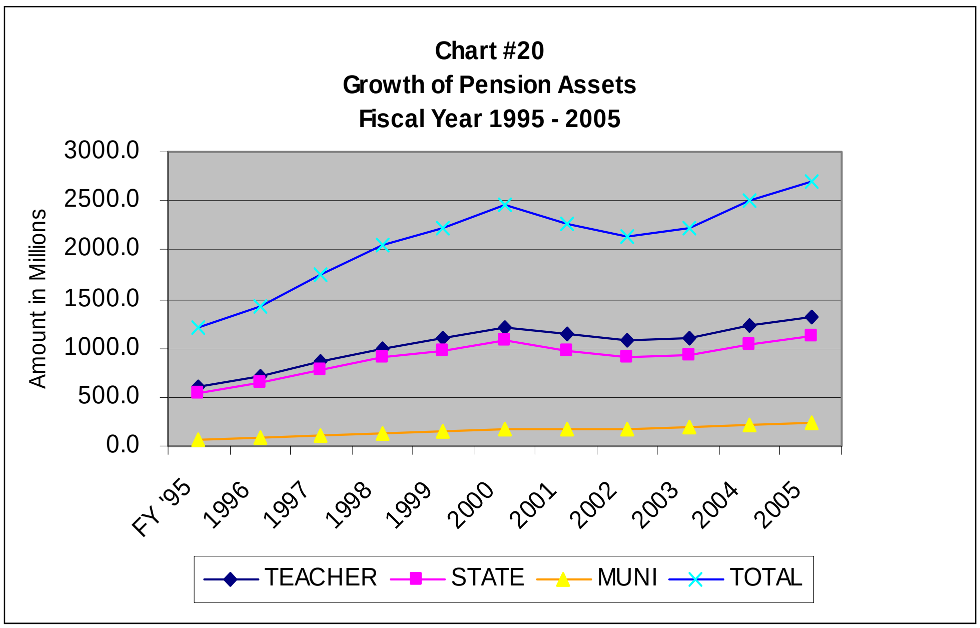


Chart #21

Long-term Investment Performance Of Vermont's Three Retirement Systems
As of June 30, 2005

Retirement System:	Last 1 Year	Last 3 Years	Last 5 Years	Last 7 Years	Last 10 Years
Teachers Composite (Gross)	9.7%	10.3%	4.7%	6.2%	9.9%
Employees Composite (Gross)	8.9%	9.6%	3.0%	5.2%	9.5%
Municipal Composite (Gross)	8.1%	8.2%	4.6%	6.1%	10.0%
Median Public Fund	9.0%	9.3%	3.8%	5.5%	9.0%

Investments (continued)

a major contributor to the overall asset growth.

For the ten years ended June 30, 2005, the median public retirement plan in the United States had an average annualized total return of 9.0%, compared with 9.5% for VSERS , 9.9% for VSTRS, and 10.0% for VMERS. Vermont's retirement pension plans have outperformed and continue to outperform the majority of public pension plans over multi-year periods.

Asset allocation is essential to the investment performance of the plan. In order to insulate the portfolios from short-term market fluctuations, the three pension systems diversify assets across a broad group of asset classes, which enables each portfolio to maintain stability through market cycles of the different asset classes. Each system's assets are invested in stocks, bonds, and real estate, with an additional small allocation to alternative investments, such as venture capital partnerships (Chart #22).

Major steps were taken to engage new investment styles for the benefit of all three retirement systems through manager changes in the asset categories of Large Cap Domestic Equities and International Equities, which were completed in the fall of 2005. All three systems have also agreed upon a common Global Fixed Income manager. At an early meeting of the VPIC following the end of the 2005 fiscal year, a decision was made to consolidate two existing Small Cap Equity Managers and hire one new small/mid-cap managers.

In the category of Large Cap Domestic Equities, eight separate account manager relationships were terminated

Chart # 22
Asset Allocation of Pension Funds as of June 30, 2005

Investment Category	Municipal	Teachers	State
Domestic Equity			
Large Cap	33%	32%	29%
Small Cap	11%	13%	12%
Total	44%	45%	41%
International Equity	16%	16%	16%
Domestic Fixed Income			
Core	28%	12%	24%
High Yield	5%	0%	5%
Total	33%	12%	29%
Global Fixed Income	0%	18%	7%
Real Estate	7%	9%	5%
Other	0%	0%	2%
Totals	100%	100%	100%

Investments (continued)

and three new managers were engaged. Collectively these new managers employ a combination of passive management and index enhancement techniques appropriate for this category designed to improve returns net of fees and moderate risk.

In the category of international equities, five separate account manager relationships were terminated and two managers were engaged (one existing prior to transition). Appropriate for this asset class, the current managers both make investment decisions based on active management, but with different and complementary styles (fundamental large cap value and quantitative multi-cap styles, respectively). In combination, these styles are expected to provide both higher and more consistent returns in the future.

The State and Municipal Systems have each transitioned Global Fixed Income Assets to a new manager that, like other new managers, has demonstrated the ability to consistently outperform style benchmarks and other peer group managers. Global Fixed Income assets in the Teachers' System will be transitioned shortly.

In the category of Small Cap Domestic Equities, five separate account manager relationships were ended and three managers (two existing) have been engaged. Two of these managers make investment decisions based on active management, with style objectives of value and growth, respectively. The third manager is index-based and addresses companies of both small and mid market capitalizations. Like the management combinations in the other equity classes discussed above, this group of managers is expected to enhance returns and moderate risk.

The formation of VPIC and unitization of the investment assets of the three Vermont Retirement Systems, as discussed earlier in this report, has improved access to the cost-effective engagement of best-in-class managers for the benefit of each System. To date, more than one-half of the approximately $2.71 billion of the three system's assets have been transitioned to new, unified manager accounts. More recently, decisions have been made in other asset classes; these decisions will be implemented in this fiscal year. Finally, VPIC is currently considering new and non-traditional asset classes that are expected to both improve each System's composite performance and through diversification reduce the volatility of investment returns.

Investment in equity securities (common stocks) includes both the right and the responsibility to vote on matters presented through shareholder proxies. A coordinated voting policy on behalf of the three Vermont Retirement Systems and the Trust Investment Account will have a larger impact on corporate and environmental policies than would the absence of such a policy. For many years, proxy votes relating to State equities have been voted at the discretion of investment managers. This has in many instances allowed for votes on the same proxy matter to be different which cancels out the potential effects of each. Furthermore, the State and its Retirement System boards sometimes have a differing perspective from investment managers as to what is truly in the long-term best interests of the systems and beneficiaries.

Investments (continued)

In Fiscal Year 2004, a joint committee of the three Vermont Retirement Systems and the State Treasurer worked together to create and adopt a proxy policy and guidelines to guide our domestic equity investment managers in proxy voting on behalf of Vermont. The State's *U.S. Proxy Voting Policy Statement and Guidelines* was adopted, effective March 1, 2004.

The Policy's corporate governance guidelines include voting policies relating to boards of directors, auditors, shareholder rights, and executive and director compensation. The Policy's corporate responsibility and accountability guidelines include voting policies on environmental issues such as global warming and environmental reporting as well as workplace issues such as equal employment opportunities, human rights, and labor codes. A copy of this policy may be obtained on the Vermont Treasurer's Web site.

A consultant was engaged to conduct bi-annual reviews of votes recorded for U.S. domestic equity managers. The first audit of proxy votes cast in calendar year 2004 revealed varying levels of policy compliance.

In calendar year 2005, a decision was made to discontinue bi-annual proxy voting reviews while continuing to require that domestic equity investment managers vote proxies consistent with the State's proxy voting guidelines. In November of 2005, the Vermont Pension Investment Committee agreed to engage the proxy consultant to provide full proxy voting services on behalf of the three Vermont Retirement Systems. Under this arrangement, all proxies will be voted by this third-party proxy service provider in accordance with stated policy. In addition, a policy for international equity proxy voting will be developed allowing for the same service provider to vote international equity proxies as well. This new proxy voting arrangement will commence in calendar year 2006.

Trust Investment Account

The 2000 Legislature authorized the establishment of a trust investment account administered by the State Treasurer for purposes of investing restricted funds with non-expendable principal balances. As of June 30, 2005, the fund had a principal balance of approximately $43.5 million, of which $31.5 million was allocated to the Tobacco Trust Fund, $8.9 million to the Higher Education Endowment Trust Fund, and the remainder to various smaller trust funds. For FY'05, the fund had a total return of 10.2% versus the target return of 6.8%. For the same period, the S&P 500 Stock Index returned 6.3% and the Lehman Aggregate Bond Index returned 6.8%.

Higher Education Trust Fund

The 1999 Legislature established the Vermont Higher Education Endowment Trust Fund and appropriated $6 million for the creation and management of the fund by the State Treasurer. An additional $1 million was added to the fund in fiscal year 2001, and $635,881 at the end of FY'02. On June 30, 2005, the fund had a market value of $8,855,599. In August of 2005, the State Treasurer authorized the distribution of 5% of the average market value of the assets over the prior 12 quarters equally among the University of Vermont, the Vermont State Colleges, and the Vermont Student

Investments (continued)

Assistance Corporation. Each received $140,553 to be applied as non-loan financial aid to Vermont students attending Vermont post-secondary institutions.

The Higher Education Endowment Trust Fund Act further provides that contributions shall include "… in any fiscal year in which a general fund surplus exists and the general fund stabilization reserve is funded to its required statutory level, funds raised by the estate tax under chapter 190 of Title 32 which are more than 125 percent of the amount projected by the emergency board in the July annual forecast made pursuant to section 305a of Title 32." This year a substantial contribution in the amount of $2,363,355.61 derives from fiscal year 2005, and this contribution became part of the Higher Education Trust Fund in July 2005. Thus the Fund's investment base is significantly increased for fiscal year 2006; depending upon investment market conditions it can be expected to generate additional returns to the Fund.

In addition to the above disbursements from the fund, the Vermont Commission on Higher Education Funding authorized the Treasurer to make available the additional 2% distribution of $168,663 to be divided equally between the University of Vermont and the Vermont State Colleges for application to their respective permanent endowments. In FY'05, the additional endowment allocation will be $84,332 for each institution, provided that it is matched on a two-to-one basis by external donations for endowment purposes by the end of the fiscal year. A copy of the State Treasurer's Annual Report to the Commission is attached as Appendix B.

Chart #23

Vermont's Expected and Actual Receipt of Tobacco Settlement Funds

Fiscal Year	Expected* ($ millions)	Actual* ($ millions)
2001	$28.47	$24.68
2002	34.18	30.92
2003	34.51	30.55
2004	28.80	25.82
2005	28.80	26.21
2006**	28.80	21.90
2007**	28.80	21.90
2008**	29.37	$33.30 to $35.30

* Source: JFO. Expected amounts shown are at time of initial settlement

** Actual column is estimated.

Tobacco Litigation Settlement Fund and the Tobacco Trust Fund

In November 1998, Vermont was one of 46 states to enter into a settlement agreement with four major tobacco companies. The State's estimated share of settlement payments at the time was expected to total $806 million over the first 25 years of payment, with an additional $156 million of strategic contribution payments to be paid between 2008 and 2017. To date, the State has received payments that total $171 million.

Pursuant to the Agreement, the expected settlement amounts are adjusted for inflation and the effect of any decreases in the sale of tobacco products to the base year. To date, these have accounted for a 10.3% decrease. It remains difficult, therefore, to predict the amount of the future payments due from the tobacco settlement that will be received by the State.

In fiscal year 2000, the Vermont Legislature established a Tobacco Litigation Settlement Fund ("Settlement Fund") to be administered by the State Treasurer and to be subject to further appropriations. For fiscal year 2006, the Legislature appropriated $17.3 million (the same as fiscal years 2001 through

Investments (continued)

2005) from the Settlement Fund to healthcare services. A total of $5.1 million was appropriated to programs in various departments for tobacco enforcement, prevention, and education programs. Additionally, $4.7 million was appropriated to substance abuse and youth protection programs in the Agency of Human Services.

The remainder of the Settlement Fund receipts is earmarked for the separately established Tobacco Trust Fund, a trust established to eventually endow the education and prevention programs. Such remaining receipts were transferred to the Tobacco Trust Fund at the end of FY'00, FY'01, and FY'02. The receipts remaining at the end of FY'03 were not transferred to the Tobacco Trust Fund but were instead transferred to the Health Access Trust Fund. Of the receipts remaining at the end of fiscal year 2004, $600,000 was transferred to the Health Access Trust Fund prior to year end, and the balance remained in the Settlement Fund. The balance of the Tobacco Trust Fund at June 30, 2005 was $31.5 million. The Health Access Trust Fund balance at June 30, 2005 was $5.4 million.

Vermont Veterans' Home

By legislative act in FY 2001, the Vermont Veterans' Home was required to transfer its endowment fund to the State for administration by the State Treasurer. In the fall of 2001, the Home transferred $455,441.85 in trust to the State. The legislation allows the State Treasurer to invest these funds, if appropriate, with the long-term investments in the Investment Trust Account. The funds were invested with the State's short-term investments until a spending policy for these funds was established by the Board of Trustees for the Vermont Veterans' Home. At the Board's September 2002 meeting, a spending policy was adopted that allowed for transfer of the funds to a fund in the State's Trust Investment Account ("TIA"). Of the amount transferred, $400,000 was deposited in the TIA fund as of October 1, 2002. In November and December of 2002, the Vermont Veterans' Home received a bequest of $410,000 that was deposited into the TIA fund as a second, separately-named fund pursuant to the terms of the bequest. On July 1, 2004 an additional contribution of $75,000 was credited to this second fund.

During fiscal year 2005 withdrawals from the Vermont Veteran's Home TIA Funds totaled $45,888. As of June 30, 2005, the balance of the fund first contributed to the TIA was $$472,938, and the balance of the second (later) fund was $$550,179, for a total of $1,023,017.

Short-Term Investing

The State Treasurer's Office manages the investment of the State's cash in its short-term investment program. The short-term portfolio earned $3.754 million in interest income in fiscal year 2005 on average daily available balances of $$178.17 million. Of this amount, $1,226,062.56 was credited to interest earning funds, and the balance of $2,528,740.72 remained in the general fund. The yield on the available cash in the portfolio was 2.11% for the year, which was within 0.11% of the average three-month treasury bill auction rate of 2.22%. The Treasurer's Office solicits offerings daily from the institutional trading desks of a number of national and local brokers in order to achieve maximum rate of return and diversification in the portfolio.

Investments (continued)

Bank in Vermont Initiative

In August 2004, the Treasurer's Office initiated the *Bank in Vermont* Program to invest state funds on a predictable basis through CDs via a competitive bidding process in banks with branches in Vermont. The program is designed to be attractive to the wide range of banking institutions in Vermont, and is predicated on the belief that investing Vermont funds in Vermont, consistent with earning a competitive rate of return, is a good policy.

Banking institutions that wish to be placed on a list of eligible institutions must complete an application/questionnaire. The responses are used to evaluate prospective candidates wishing to provide investment services for CDs, and to determine maximum levels of participation based on the bank's size, financial health, risk factors, credit ratings, and capital levels.

Banks so pre-qualified are then eligible to participate in a monthly competitive bidding process for certificates of deposits. Banks that have been pre-qualified are notified in writing and/or e-mail in advance of this schedule, and bidding is done on a Web site designed by the Treasurer's Office. A block of funds is set aside for the scheduled bid in specified time frames. Some of the funds may be short duration, while a portion is set aside for longer maturities, depending on the yield curve.

As of December 31, 2005, these 17 banks have been pre-qualified to participate:

- Citizens Bank
- Chittenden Trust Company
- Connecticut River Bank
- Factory Point National Bank NA
- First Brandon National Bank
- First Community Bank
- Key Bank
- Lyndonville Savings Bank and Trust Company
- Mascoma Savings Bank
- Merchants Bank
- Northfield Savings Bank
- Passumpsic Savings Bank
- Peoples Trust Company of St. Albans
- Randolph National Bank
- TD Banknorth Vermont
- The Bank of Bennington
- Union Bank

Since its inception in August 2004, $133.4 million in Certificates of Deposit (CDs) had been awarded through December 2005. As of December 31, 2005, $40 million is invested in certificates of deposits of varying maturities with rates well above comparable maturity Treasury rates.

Financial Operations

ACCOMPLISHMENTS IN 2005

- **Completed timely reconciliation of all bank accounts, now within 30 days of the accounting closing date on VISION.**
- **Improved procedures to work with user departments to resolve reconciling items.**
- **Improved controls over departmental bank accounts.**
- **Consolidated many bank accounts, reducing administrative overhead.**

Financial Operations

Overview

The Financial Operations division is responsible for the treasury transaction services, accounting, Act 68 (school tax) receipts, and providing assistance in cash and investment matters for the annual state audit.

The Financial Operations Division is the focal point for all money movement within the State. There are 22 operating accounts in two banks, five pension/retirement accounts, and two deferred compensation accounts from which funds are moved to fund the various transactions of the state. In addition, there are approximately 200 agency bank accounts for which this division exercises oversight.

This division acts as the State's banker, moving funds to cover payroll, vendor, and other disbursements, transferring receipts to interest-bearing accounts and investment instruments as quickly as possible to maximize return, and projecting cash needs so that fund movements can be efficient and cost effective. This involves the movement of over $4 billion in both net receipts and disbursements annually.

In its role as the state's financial services provider, the Financial Operations division processed approximately 1.63 million payments in Fiscal year 2005. Approximately 37% were conducted electronically, as opposed to the use of paper checks. The Division's goal is to continue increasing the proportion of transactions that occur electronically, working with vendors, user departments, and the Department of Finance and Management.

The division works with commercial banks to put preventative measures into place that provide internal control safeguards over the state's assets. This includes the use of automated positive pay accounts, timely reconciliation, and various warrant control protocols.

This division also monitors Act 68 tax receipts from towns. If a town is delinquent in its Act 68 payment, the division works with the town to obtain proper payment. Unresolved delinquencies in payments are referred to the Attorney General's Office for collection.

Reconciliations and Electronic Payments

In fiscal 2005, 70,776 deposits were processed to state accounts. Staff processed over 2,400 payment replacements.

Significant internal control upgrades have also been implemented, in cooperation with the Treasurer's internal audit staff. Staff activities are segregated so that one individual doesn't have the ability to both initiate and record payment activity. Cash transfer procedures require multiple reviews and sign-off. Joint reviews of outstanding reconciling items with agencies/departments state-wide have resulted in the resolution of important procedural and system issues, thereby significantly reducing the amount of aged items on the reconciliations.

Timely reconciliation had been a historical issue for the Treasury. The combination of the migration to the

Financial Operations (continued)

VISION system and, at the same time, the movement of the State's primary bank accounts to a new bank resulted in a number of procedural changes for the Treasury, the Department of Finance and Management, and the various user departments/agencies in 2001. Reconciliation processes were adversely affected by this change. Working cooperatively with the Treasury's business partners, the number of user/department reconciling items has been considerably reduced, reporting issues resolved, and new procedures established. The Treasury has since met its stated goal of completing all bank reconciliations within 30 days of the monthly close of the State's accounting system (VISION). In fact, this goal has been met for the last 22 consecutive months.

Moving further from a paper-based payments system to electronic forms has provided increased safety, while at the same time reducing operational costs. In addition to vendor payments, the Treasurer also issues payroll for state employees and benefit payments for the three retirement systems. In December of 2005, 84% of retired municipal employees, 90% of retired State employees, and 93% of retired teachers received their monthly benefit payments via direct deposit. This is an increase from the December 2004 percentages of 82%, 89%, and 92% respectively. Currently, 7,684 State employees, or 83% of the work force, have their biweekly pay deposited directly to their bank accounts. This is up from 7,400, or 81%, from the prior year.

Banking

TD Banknorth serves as the State's master banking contractor. Bank personnel and Treasury staff work together continually to provide new, improved services and processes with the goal of greater efficiency. Check images are available on-line for 90 days. This eliminates the need for staff to obtain CDs for the more recent check images that need to be researched. Treasury personnel have secure access to up-to-the minute account information to initiate wire transfers and automated transfers of funds, process stop-payments, utilize reporting functions, access check services, and be assured of secure messaging. All these features are complementing the effort to improve cash flow forecasting and funds management.

In November of this past year, Government Banking Division senior managers met with Treasury financial and operations staff to define critical functions and assure that all processes and functions are fully identified and accounted for in planning for a business continuation process. In the event that a continuation plan was forced to be put into effect, both the bank and the State would need to process critical transactions and maintain the integrity of all the data.

This framework building will be on-going in 2006 and will take all reasonable steps to minimize the impact of a loss of services to our customers, and to fully restore these services as soon as possible after any potential disruption.

Financial Operations (continued)

Act 68 Receipts

The Treasurer's Office monitors the receipt of payments mandated by Act 68 after the Departments of Education and Taxes have notified towns and school districts of their respective liabilities. In FY2005, all towns and school districts made their Act 68 payments.

As of December 15, 2005, all districts except three made their Act 68 payment that was due on December 1, 2005, as required. The Treasurer's Office worked with the delinquent entities to encourage compliance. Payments and all interest for late payment have since been received, obtaining 100% compliance.

Municipal Equipment Loan Fund

The Municipal Equipment Loan Fund (MELF) is governed by Vermont Statute Title 29, Chapter 61. The fund was created for the purpose of providing loans on favorable terms to municipalities for the purchase of construction, fire, emergency, or heavy equipment or vehicles. The amount loaned cannot be more than 75% of the purchase price of the equipment and is repaid annually with principal and interest for no more than three years. For loans to a single municipality, the interest rate is two percent. For loans to two or more municipalities jointly purchasing equipment, no interest is assessed. The committee, consisting of the State Treasurer, Secretary of Transportation, Commissioner of Public Safety, and Commissioner of Motor Vehicles meets semi-annually to review and approve applications.

The legislature originally appropriated start-up capital of $2,000,000 for this fund. Each new fiscal year the fund receives spending authority (no hard dollars are appropriated) of $1,500,000 for revolving loans to municipalities up to that amount. The annual principal and interest payments replenish the fund and can be used to make new loans. Since the MELF is a restricted fund, interest earned on its assets is retained in the fund. Over the life of the program, the fund has realized approximately $770,000 in interest earnings. As of June 30,2005, the fund had total net assets of $2.76 million, with loans receivable comprising $1.6 million of the total.

The committee has authority to approve revolving loans up to $1.5 million each fiscal year. In 2005, the committee approved 13 applications for a total of $669,642.

Unclaimed Property

ACCOMPLISHMENTS IN 2005

- **Returned a record $6.48 million to 7,828 claimants. This is a substantial increase over the previous four-year average of $1.88 million.**
- **Developed new compliance procedures for business and others holding unclaimed property.**
- **Collected $7.6 million in unclaimed property in Fiscal Year 2005.**
- **Transferred $6.3 million to the General Fund in Fiscal Year 2005.**

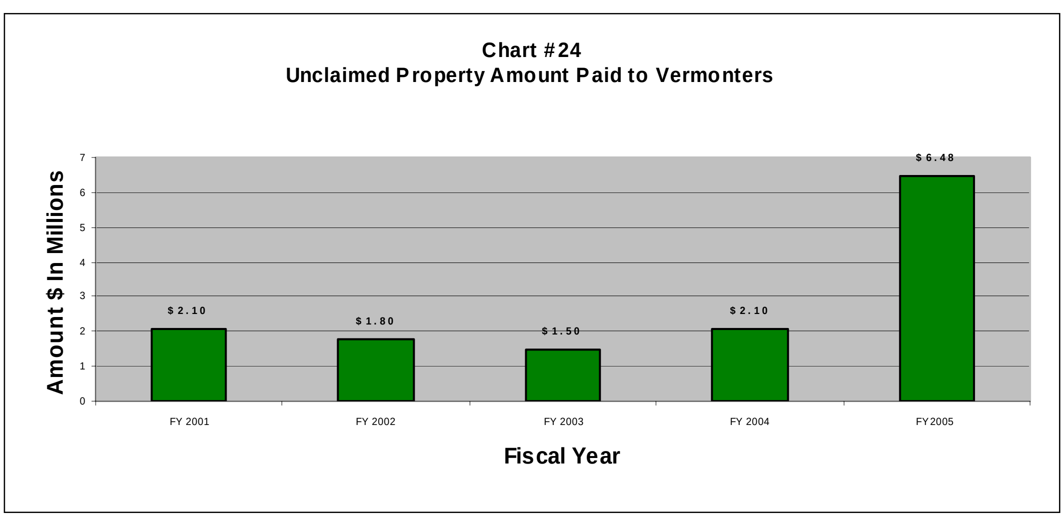
Unclaimed Property Division

The primary function of the Unclaimed Property Division is to locate and return various forms of unclaimed financial property to the rightful owners or their heirs. This property could be forgotten bank accounts, uncashed pay checks, unclaimed security deposits, unused gift certificates, etc. It is most often in the form of money, but it can also be stocks, mutual funds, and contents of safe deposit boxes. The property comes from many sources including banks, credit unions, corporations, utilities, insurance agencies, retailers, and governmental agencies throughout the United States. The Vermont State Treasurer's Office acts as custodian to safeguard the assets until they can be claimed by the rightful owners or heirs.

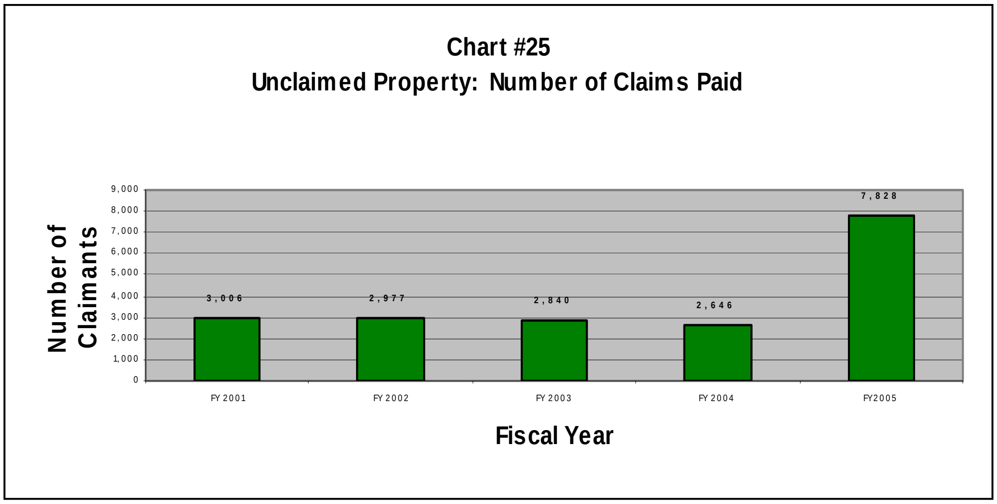
In fiscal year 2005, $6.48 million in claims (Chart #24) was paid to 7,828 claimants (Chart #25). This is a substantial increase over the previous four-year average of $1.88 million. The average claim paid as $834. The largest claim paid was $405,120.

In addition to processing more claims, the Office has achieved significant efficiencies in its payment processes. A new unclaimed property management system (UPMS) was put into place in Fiscal Year 2004. New interfaces to the state's financial system as well as some retooling of the organizational structure have significantly improved the processing time for claims, from an average of 90+ days in past years to an average of fewer than 14 days during 2005.

This increased claim activity is directly attributable to statutory changes put into place over the past two years. Under prior law, most types of unclaimed property were forwarded to the Treasurer's Office after a five-year "dormancy" period. In 2004, changes to the statute reduced that holding period to three years, as is the case in several other states. In 2004, a record $19.2 million was collected.



Unclaimed Property Division (continued)



Since much of this new money was received in May 2004 (the filing date for most companies and financial institutions), the Treasury's goal was to reach out to citizens over this fiscal year and assist them in filing claims for assets that rightfully belong to them. Over the past year, the Treasurer's Office has accelerated outreach activities to reach more Vermonters. The office staffs a booth at the Champlain Valley Exposition so attendees can look up their names on the computer database. As a result, 909 people made claims for a total of $172,376.89, based on applications made at the booth. The Treasurer and Unclaimed Property Office staff have met with City and Town Clerks to provide information on property held on behalf of potential claimants in their municipalities. Similar lists have been provided to Legislators for individuals in their districts. This past year, a newspaper insert was prepared for all new property received over the prior year. Copies were also sent to local libraries. Radio public service announcements were also utilized. In October 2004, the Treasurer's Office made significant changes to its Web site to facilitate the claims process. Since then, there have been over 350,000 "hits" on the Unclaimed Property page. These initiatives proved to be a very effective approach as evidenced by the numbers.

The Office also has a responsibility to annually receive information and funds for new properties from "holders" of unclaimed property. Fiscal year 2004 was an anomaly in that the demutualization and dormancy statute changes brought in substantial funds ($19.2 million). Prior to the statutory changes, receipts from holders approximated $4 million year. In Fiscal year 2005, receipts totaled $7.69 million (Chart #26).

Irina Aylward (L) and Linda Bouffard (R) review stock certificates related to an unclaimed property claim.

Unclaimed Property Division (continued)

To date, Vermont's compliance has been largely voluntary. While most companies do comply, others do not. As a result of preliminary reviews, the Office began the first stages of an enhanced compliance program.

Operating under the assumption that not all holders are aware of their responsibilities, our compliance efforts stared with education. In April 2005 the Office completed a first-ever comprehensive Holder Manual and posted it to the Treasurer's Web site. The Office also produced a short brochure which was mailed to businesses. Also in April, a reminder mailing was distributed to all holders that reported, at least $5,000 for the previous report year.

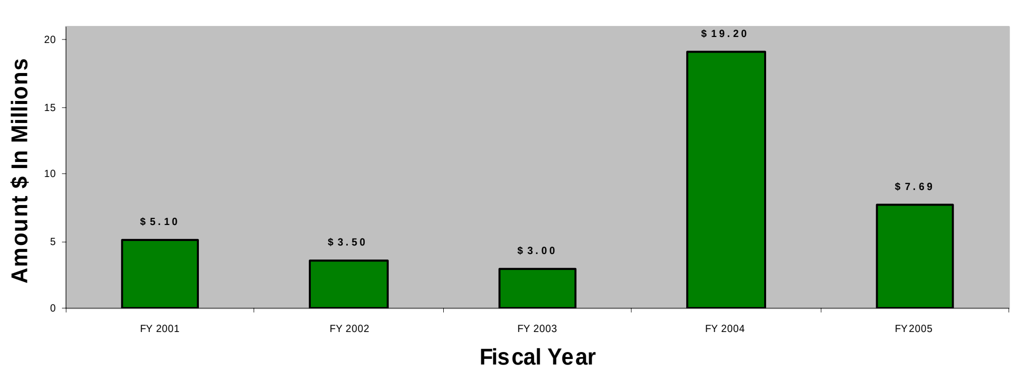
In May 2005, the Office conducted an educational session at the Annual Meeting of the CPA Society. The focus of the presentation was to make CPAs aware of their client company responsibilities relative to unclaimed property.

In May 2005, the Unclaimed Property Office also hosted a booth at the 2005 Expo, providing the majority of the businesses participating in the expo with the informational package on Unclaimed Property Reporting. In August 2005, the staff conducted a workshop on Unclaimed Property reporting for State Departments & Agencies to assure all agencies were in compliance. The Treasurer and staff met with the Vermont Bankers Association Executive Board in September to review unclaimed property reporting compliance issues. A training workshop is scheduled for January 2006 for banking institutions.

Four additional workshops were held In November, three were specifically intended for the Vermont Higher Education entities; the fourth workshop was another for State Departments & Agencies.

In addition, we have been working with several companies and educational institutions, that have not previously complied, to bring them current. Various financial review procedures will be used, reviewing records back several years, to bring compliance up-to-date. Over the next year the Treasurer's Office will also be instituting an audit program to assure compliance with companies that have not demonstrated cooperation.

Chart #26
Unclaimed Property Turned Over to the State Treasurer



Unclaimed Property Division (continued)

Unclaimed Property Division Coordinator Al LaPerle (L) and Treasurer Jeb Spaulding return contents of a safe deposit box to a local resident.

In Fiscal Year 2004, 1,894 new holders were added to UPMS. An additional 624 holders were added in FY 2005. We expect to see additional improvement over the next year.

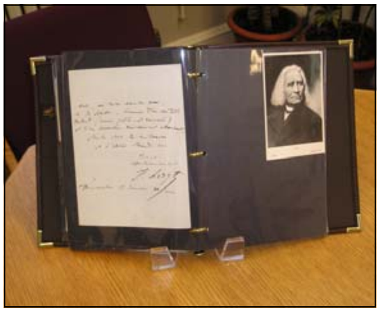
Safe Deposit Boxes

In addition to cash property, the Treasurer's Office often receives safe deposit boxes from local banking institutions. Some have considerable monetary value, while the contents of others may be family keepsakes. A sample listing includes:

- Suitcase containing silver bowls, plates, silverware, etc.;
- A war bond issued in 1944;
- Foreign currency from a variety of countries, issue dates early 1900s through 1946;
- Hundreds of silver dollars, mint state, collector coins;
- A marriage certificate and a church program;
- Army tag, shares of stock, two wills, birth certificate, and discharge papers;
- Box of Topps baseball cards;
- Repair bill for sports car.

This past year the Treasurer's Office was able to return an interesting collection, kept in a dormant safe deposit box, to its owner. This collection includes cards, photos, and other memorabilia of famous artists, painters, sculptors, and composers. In each case the memorabilia is accompanied by an original letter or autograph. Notables include Paul Cezanne, Henri Matisse, Ira Gershwin, Johannes Brahms, Grandma Moses, Norma Rockwell, Salvador Dali, Pablo Picasso, and many others.

In this case, the owner had forgotten about the material when the family moved. With the assistance of a town clerk, this Office was able to track down the individual and return the collection.



Although the box contents are not specifically listed for security reasons, safe deposit boxes are listed as property on the Treasurer's Unclaimed Property Web site. Vermonters are urged to check the site at www.vermonttreasurer.gov .

Audit Compliance

Internal audit and control is broadly defined as a process, affected by an organization's management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations;
- Safeguarding of assets;
- Reliability of financial reporting; and
- Compliance with applicable laws and regulations.

Internal controls are tools that help managers be effective and efficient while avoiding serious problems such as theft, fraud, and mismanagement of resources; overspending; operational failures; and violations of law. Internal controls are the structures, policies, and procedures put in place to provide reasonable assurance that management meets its objectives and fulfills its responsibilities. The assessment of internal controls must be based on procedures sufficient both to evaluate the design and to test the operating effectiveness.

The Audit Compliance Division was created within the State Treasurer's Office six years ago. Since that time, the Division has conducted independent reviews of the diverse operations and controls within the office to establish key components of internal control, evaluate whether acceptable procedures and policies are followed, and assure that resources are being used economically and effectively in reaching the organization's objectives.

The Division plays a key internal control role with the Accounting Division in the monthly cash reconciliation reviews. In addition, the Division has instituted a monthly procedure for the preparation and review of the pension funds' financial statements that must be prepared in accordance with Government Accounting Standards Board (GASB) standards.

The Division has also worked closely with the Department of Finance and Management to review, revise, and improve operational procedures.

In addition, the Audit Compliance Division has been actively involved in reviewing the work performed by the State's contracted third-party service providers, primarily the custodians of the State's pension funds. Annually, the Division requests a copy of the provider's most recent audited financial statement and the Statement on Auditing Standards (SAS) #70, which report on the internal controls of the service organization.

The Sarbanes-Oxley Act of 2002 requires that a public company's annual financial report include an internal control report from management. This report must include a statement identifying management's framework used to evaluate the effectiveness of the company's internal controls over financial reporting.

The Division realizes that the monitoring of internal controls is an essential component of the internal control process, and thus evaluates these reports and other reports relative to ensuring the safeguarding of the assets of the Treasurer's Office.

Technology Services

The Technology Services Division is committed to provide programming and technical support services to the Office of the State Treasurer for the purposes of enhancing efficiency, accuracy, and security, and to contribute to the Office's commitment to a high standard of service to the State of Vermont, its clients, and its citizens. This Technology Division provides support to the entire range of software supporting the operations of the Treasurer's Office, including bank reconciliation software, check and EFT issuance, unclaimed property, and the various programs supporting the retirement services for the State's 42,000 active, vested, and retired members.

During Fiscal Year 2005, the Technology division developed and implemented an interactive Web entry system for the Vermont Municipal Employees' Retirement System (VMERS). Modeled after the highly successful Teachers' entry system deployed in 2004, it allows municipal payroll officers to submit their quarterly contributions reports online. Like its Teachers' counterpart, it is self-balancing and shows all bank remittances to date.

The Office of the State Treasurer's network experienced several improvements in 2005, including the addition of Active Directory Services, a WSUS server (for automatically applying updates to Microsoft OS and desktop software) an upgrade to Office 2003 (Word, Excel, Outlook, PowerPoint, Publisher, and Access). Also in 2005, the office went to the DII statewide Exchange server for e-mail and scheduling. Due to the office's move from 133 State Street to 109 State Street, it is now connected to its network servers via a fiber connection.

The Technology team has also played a key role in the development of the multi-year retirement reengineering project, providing technical assistance on the legacy software systems, network issues, and in the evaluation of the functionality of proposed system software.

Each year the Treasurer's Office nominates an employee or a team as part of the Governor's State Employees Public Service Recognition award. The Treasury "Employees of the Year" for 2005 are the Technology Services Team. The team members are:

Dan Fine - Dan is the director of Technology Services. He has worked for the State for 30 years and directly for the Treasurer's Office since 1991. In 2004, he developed the mainframe side of a Web-based data entry system for Teachers' Retirement payroll officers, participated in the preliminary stages of the retirement re-engineering project, and wrote numerous enhancements to the mainframe retirement system.

Lane Safford - As our network administrator, Lane is responsible for all aspects of the Treasurer's computer network. He has been with the State since 1988 and the Treasurer's Office since 1998. In 2004 he performed a major upgrade to the network, and coordinated many improvements to the Unclaimed Property system.

Technology Services (continued)

Darryl Smith - As our systems developer, Darryl performs the dual role of database programmer and Web developer. He came on staff in 2001. He was key in the development and deployment of the Treasurer's new Web sites with their attractive interfaces and improved functionality.

All of the behind-the-scenes (and many times underappreciated) activities performed by this team form the foundation from which other Treasury employees can do their jobs – counsel an employee considering retirement, pay our 10,000 retirees, re-unite a citizen with his or her lost property, or invest billions of dollars of the State's operating and pension funds. The IT team's dedication, commitment, and drive for excellence give the Treasurer's Office staff the opportunity to make a positive difference for Vermonters.

Governor Jim Douglas presents the 2005 State Treasurer's Offfice Employees of the Year Award to Lane Safford and Darryl Smith.

Below, Treasurer Jeb Spaulding congratulates the 2005 Award-winning IT team of Lane Safford, Dan Fine, and Darryl Smith.

Legislative Reporting Requirements

Brandon Training School

Section 23 of Act 62 (the so-called Capital Bill) of the Public Acts of 1995 specifies that the State Treasurer shall notify the chairs of the Senate and House Institutions committees upon receipt of monies from the sale of the Brandon Training School property, as well as certain federal receipts associated with the Vermont Veterans' Home. For fiscal year ending June 30, 2005, the State has timely received amounts due from the federal government associated with the Vermont Veterans' Home. There were no sales of property belonging to the Brandon Training School in 2005.

MacBride Principles

Act 50 of the Public Acts of 1989 specifies that the State Treasurer and the Retirement Boards compile a list of corporations in which the State Treasurer and Retirement Boards have invested funds that conduct business in Northern Ireland. Notifications from external investment managers listing such businesses are due in the Treasurer's Office on January 1 of each year, and these notifications are kept on file in the Treasurer's Office. The Act further requires that the Treasurer and the boards of the trustees of the Vermont State Employees' Retirement System and the Vermont State Teachers' Retirement System shall support the MacBride Principles worker equality and security issues through support of shareholder issues. The Treasurer's Office and the trustees comply with Act 50 by mandating MacBride Principles compliance through investment guidelines to be observed by investment managers. Recently adopted proxy voting guidelines approved by the three Vermont Retirement Systems and the Treasurer's Office for US domestic equity managers also specify manager voting compliance with MacBride principles.

Burma (Myanmar)

Act 13 of the Public Acts of 1999 specifies that the Treasurer shall implement the purposes of the Act by voting in favor of shareholder resolutions concerning an individual company's doing business with the government of Burma. In addition, the Treasurer shall separately notify the company that Vermont wishes to convey its grave concerns regarding the company's economic ties to the government of Burma. The Treasurer complies with this Act through measures including mandating compliance through investment guidelines that must be observed by investment managers. Recently adopted proxy voting guidelines adopted by the three Vermont Retirement Systems and the Treasurer's Office for US domestic equity managers also specify manager voting compliance including support of labor standards in connection with a company's involvement in Burma, and reporting on Burmese operations and activities.

Survivors of Emergency Personnel

Act No.33, passed this last legislative session, changes the name of the "Firefighters' Survivor Benefit Fund" to the "Survivors of Emergency Personnel Benefit Fund." Originally established

Legislative Reporting Requirements (continued)

by the Legislature in 2002, the fund has been expanded to include ambulance service, emergency medical, first responder service and volunteer personnel. A review Board administers the grant of a one-time monetary benefit to the survivor or survivors of emergency personnel employed by or who volunteer for the state of Vermont, a county or municipality of the state, or a nonprofit entity which provides services in the state, who die in the line of duty or of an occupational related illness. The board met once during the year. Thankfully, no benefit awards were required to be paid out to survivors this past year. The fund currently has assets of $215,500. The governor is requesting an additional $10,000 of funding in the current budget process.

Credit Card Payments

This past year, our office continued to work with departments to facilitate acceptance of credit cards. The Treasurer's Office contracts with TDBanknorth Merchant Services, a division of TDBanknorth, to provide credit and bank card services. Acceptance of credit and debit card payments is widely practiced in many agencies and departments as a method of payment of registration fees, licenses, penalties, fines, durable goods, park reservations, interest, and payment of taxes. As we continue with advances into the e-commerce arena, Vermonters should be provided with more convenient ways to deal with government. In addition to public convenience, electronic processing of consumer and business purchases for goods and services from the state improves governmental cash flows, offers greater financial security, and reduces the overhead costs associated with the handling of currency.

Each agency/department that accepts credit/debit card payments for goods and services is responsible for the payment of associated fees. Qualified discounts increase as sales transaction volumes rise, especially for card-not-present accounts. This indicates that more and more transactions are being processed electronically.

Chart #27
Credit Card Payments by Department

Department	YTD Net Sales 2005	YTD Net Fees 2005
VT Dept. of Liquor Control	12,070,850.57	245,546.12
VT Dept. of Motor Vehicles	3,943,742.48	18,140.70
VT Dept. of Taxes	2,485,279.75	6,961.19
VT Dept. of Fish & Wildlife	388,322.50	5,562.15
VT Dept. of Forest, Parks & Recreation	2,046,532.27	66,822.89
VT Dept. of Health	152,157.00	3,214.92
Vermont Life Magazine	434,723.30	10,357.35
Vermont Judicial / Courts		480.00
Agency of Commerce & Community Development	15,570.00	1,512.82
Center for Crime Victims Services	24,724.08	1,253.52
TOTAL	21,561,901.95	359,851.66

Appendices

A. **Pension Trust Fund Statements for FY 2005**

B. **Annual Report on the Higher Education Trust Fund**

C. **Executive Summary:** ***Report of the Commission on Funding the Vermont State Teachers' Retirement System***

State of Vermont
Pension Trust Funds
Combining Statement of Plan Net Assets
June 30, 2005
(with comparative totals for June 30, 2004)

	Vermont State Retirement Fund	Vermont State Defined Contribution Fund	State Teachers' Retirement Fund	Single Deposit Investment Account	Vermont Municipal Employees' Retirement Fund	Vermont Municipal Employees' Defined Contribution Fund	Totals June 30, 2005	Totals June 30, 2004
ASSETS								
Cash and Short-term Investments	$ 59,398,297	$ 230,664	$ 30,610,333	$ 13,148,029	$ 1,947,598	$ 81,541	$ 105,416,462	$ 85,598,541
Receivables								
Contributions	3,249,630	112,706	1,972,563		1,583,884	7,671	**6,926,454**	5,683,895
Investments Sold	98,346,810		5,751,503		716,556		**104,814,869**	225,327,196
Interest and Dividends	5,548,076		21,385,072	2,790,288	1,282,008		**31,005,444**	12,421,287
Other Receivables	32,112		27,788		10,198,775		**10,258,675**	9,935,779
Total Receivables	**107,176,628**	**112,706**	**29,136,926**	**2,790,288**	**13,781,223**	**7,671**	**153,005,442**	**253,368,157**
Due from Other Funds	**30,644**		**4,000,000**		**158,809**		**4,189,453**	**4,484,624**
Investments								
Fixed Income	382,246,751		388,763,569	99,705,346	70,913,956		**941,629,622**	814,155,054
Common and Preferred Stock	622,778,271		798,163,313		120,169,796		**1,541,111,380**	1,379,889,222
Mortgages	-						**-**	2,069
Real Estate/Venture Capital	73,235,424		124,543,920		18,299,561		**216,078,905**	196,010,970
Mutual Funds	-	32,630,082			38,695,998	9,009,360	**80,335,440**	170,047,390
Total Investments	**1,078,260,446**	**32,630,082**	**1,311,470,802**	**99,705,346**	**248,079,311**	**9,009,360**	**2,779,155,347**	2,560,104,705
Prepaid Expenses	**1,088,898**	**18,769**	**906,114**				**2,013,781**	1,662,231
Total Assets	**1,245,954,913**	**32,992,221**	**1,376,124,175**	**115,643,663**	**263,966,941**	**9,098,572**	**3,043,780,485**	**2,905,218,258**
LIABILITIES								
Accounts Payable								
Investments Purchased	124,814,748		41,419,123	14,726,541	5,270,224		**186,230,636**	242,427,713
Due to Other Funds		30,644			-	158,809	**189,453**	484,624
Other	872,898	2,857	1,104,524		218,335	42,324	**2,240,938**	2,227,803
Accrued Salaries Payable	20,118		68,110		11,647		**99,875**	57,630
Total Liabilities	**125,707,764**	**33,501**	**42,591,757**	**14,726,541**	**5,500,206**	**201,133**	**188,760,902**	**245,197,770**
Net Assets Held in Trust for Pension Benefits	**$ 1,120,247,149**	**$ 32,958,720**	**$ 1,333,532,418**	**$ 100,917,122**	**$ 258,466,735**	**$ 8,897,439**	**$ 2,855,019,583**	**$ 2,660,020,488**

State of Vermont
Pension Trust Funds
Combining Statement of Changes in Plan Net Assets
For the Year Ended June 30, 2005
(with comparative totals for June 30, 2004)

	Vermont State Retirement Fund	Vermont State Defined Contribution Fund	State Teachers' Retirement Fund	Single Deposit Investment Account	Vermont Municipal Employees' Retirement Fund	Vermont Municipal Employees' Defined Contribution Fund	Totals June 30, 2005	Totals June 30, 2004
ADDITIONS								
Contributions								
Employer	$ 36,493,435	$ 1,501,312	$ 24,446,282	$	$ 8,058,810	$ 523,133	$ 71,022,972	$ 60,160,215
Plan Members	15,112,105	611,344	21,158,452		7,404,119	524,718	44,810,738	42,409,184
Transfers from Other Pension Trust Funds	777,792	292,021	373,705		298,475		1,741,993	1,830,028
Other Contributions	-	252,626	-			853	253,479	2,195,732
Total Contributions	**52,383,332**	**2,657,303**	**45,978,439**	**-**	**15,761,404**	**1,048,704**	**117,829,182**	**106,595,159**
Investments								
Net Appreciation (Depreciation) in Fair Value of Investments	49,632,662	1,126,085	72,149,561	(78,969)	7,207,480	300,759	130,337,578	282,266,417
Dividends	12,553,872	928,507	15,302,583		5,808,957	218,000	34,811,919	25,132,474
Interest	19,157,559	4,698	17,290,972	5,488,561	3,662,049	1,100	45,604,939	39,110,345
Security Lendings Income	1,897,192		1,660,963		556,146		4,114,301	1,704,651
Other Income	12,604,314		14,435,740		2,161,094		29,201,148	769,642
Total Income from Investments	**95,845,599**	**2,059,290**	**120,839,819**	**5,409,592**	**19,395,726**	**519,859**	**244,069,885**	**348,983,529**
Less Investment Expenses								
Investment Managers and Consultants	3,671,522	7,695	4,254,303	249,570	715,091		8,898,181	9,481,225
Security Lending Expenses	1,721,354		1,526,822		514,774		3,762,950	1,327,936
Total Investment Expenses	**5,392,876**	**7,695**	**5,781,125**	**249,570**	**1,229,865**	**-**	**12,661,131**	**10,809,161**
Net Investment Income	**90,452,723**	**2,051,595**	**115,058,694**	**5,160,022**	**18,165,861**	**519,859**	**231,408,754**	**338,174,368**
Total Additions	**142,836,055**	**4,708,898**	**161,037,133**	**5,160,022**	**33,927,265**	**1,568,563**	**349,237,936**	**444,769,527**
DEDUCTIONS								
Retirement Benefits	48,893,673	2,837,490	60,147,731	5,845,481	6,418,097	279,854	124,422,326	114,435,183
Refunds of Contributions	1,201,475		840,919		963,800		3,006,194	2,515,926
Death Claims	201,006		263,359		176,445		640,810	478,080
Transfers to Other Pension Trust Funds	635,618		682,438		423,937		1,741,993	1,830,028
Operating Expenses	12,585,121	213,210	11,220,373		367,810	41,005	24,427,519	19,346,129
Total Deductions	**63,516,893**	**3,050,700**	**73,154,820**	**5,845,481**	**8,350,089**	**320,859**	**154,238,842**	**138,605,346**
Net Increase	**79,319,162**	**1,658,198**	**87,882,313**	**(685,459)**	**25,577,176**	**1,247,704**	**194,999,094**	**306,164,181**
Net Assets Held in Trust for Pension Benefits:								
Beginning of Year	**1,040,927,987**	**31,300,522**	**1,245,650,105**	**101,602,581**	**232,889,559**	**7,649,735**	**2,660,020,489**	***2,353,856,307***
End of Year	**$ 1,120,247,149**	**$ 32,958,720**	**$ 1,333,532,418**	**$ 100,917,122**	**$ 258,466,735**	**$ 8,897,439**	**$ 2,855,019,583**	**$ 2,660,020,488**

TO: Commission on Higher Education Funding

FROM: Jeb Spaulding, State Treasurer

RE: Annual Report on the Higher Education Trust Fund

DATE: August 23, 2005

I am pleased to present the State Treasurer's sixth annual report on the Higher Education Trust Fund. This fund was established in the Office of the State Treasurer by Act No. 27 of the General Assembly in 1999 and was initially funded with an appropriation of $6 million. Additional appropriations include $1 million in 2001 and $635,881.49 in 2002 and, as discussed further below, $2,363,355.61 in 2005. The Act was amended in 2001 to provide that in August of each year, the State Treasurer shall withdraw 5% of up to a 12-quarter moving average of the fund's assets and divide the amount equally among the University of Vermont, the Vermont State Colleges, and the Vermont Student Assistance Corporation.

During fiscal year 2005, the Higher Education Trust Fund dollar weighted return was 10.17%. This return compares to the Lehman Aggregate Bond Index return of 6.80% and to the S&P 500 Stock Index of 6.32% for the same period, and exceeds the Fund's target rate of 6.76%. The 5% distribution available this year is $421,657.83 in total, or $140,552.61 each for UVM, VSC, and VSAC; the distribution made following Fiscal Year 2004 was $135,482.92 for each institution. (See Appendix A for quarterly market values and distributions for fiscal year 2005.)

Act No. 27 further provides that in August of each year, the Commission on Higher Education Funding may authorize the State Treasurer to make an additional amount equal to up to 2% of the fund's average assets available to UVM and the Vermont State Colleges for the purpose of creating or increasing a permanent endowment fund. The amount appropriated, however, cannot exceed an amount that would bring the fund balance below the $6 million initial appropriation plus any additional contributions to principal.

At its meeting last year, the Commission authorized this 2% appropriation in the amount of $162,579.50, or $81,289.75 each, for distribution to the University of Vermont and the Vermont State Colleges dependent upon a finding by the Commission that the terms of this appropriation have been met. Each institution was given until the end of fiscal year 2005 to match the appropriation by raising twice that amount, or $162,579.50, and to certify to the Commissioner of Finance and Management that it received private donations in the requisite amount and that the funds will be used to create or increase a permanent endowment at the respective institution. Each of these institutions is in the process of establishing the required certification.

After payments of $421,657.83 and $162,579.50, the balance in the fund at the beginning of fiscal year 2006 totals $8,271,362.58.

All principal contributions to date total $7,635,881.49 (see Chart #1). This represents the current minimum balance that must be maintained in the fund. The 2% distribution proposed for this year of $168,663.14 would leave a balance of $8,102,699.44 excluding any gains from investment activity in Fiscal Year 2006. If the committee authorizes this distribution, each institution's share will be $84,331.57, with a required match to be raised by each entity in Fiscal Year 2006 of $168,663.14. Chart #2 is a graphical depiction of distributions, including this 2% distribution subject to committee approval.

An accounting of the fund balances is provided below:

Ending balance FY 2004		$8,625,716.81
Contributions received FY 2005		-0-
Opening balance FY 2005		8,625,716.81
Distribution August 2005		(555,166.37)
Income earned fiscal year 2005		378,889.16
Appreciation (Depreciation) FY 2005		438,983.33
Fees and Other Charges FY 2005		(32,823.02)
Balance June 30, 2005		8,855,599.91
5% of 12-Quarter Moving Average June 30, 2005		(421,657.83)
Distributions: University of Vermont	(140,552.61)	
Vermont State Colleges	(140,552.61)	
Vermont Student Assistance Corp.	(140,552.61)	
2% Income Available for Endowments from FY 2004		(162,579.50)
Balance after distributions		8,271,362.58
Addition to Principal		- 0 -
Post-distribution balance FY 2006		$8,271,362.58
2% Income Available for Endowments from FY 2005 (requires institutional match in FY 2006)		$168,663.14

I have attached a spreadsheet as Appendix B that shows the total return of the entire Trust Investment Account, of which the Higher Education Trust Fund at $8,855,599.91 (prior to cash distributions made in fiscal year 2006) comprises approximately 20%. The Tobacco Trust Fund comprises 73% of the account, or $31,515,641.45, and the remaining 7% is made up of eight small unexpendable trusts that total $507,153.80, the ANR Stewardship Fund at $579,503.29, two Veterans' Home trusts totaling $1,023,116.92, and the most recent addition to the Trust Investment Account (June 2005), the Fish and Wildlife Trust Fund at $1,057,786.21. Chart #3 displays the relative share of the Higher Education Trust Fund compared to the entire fund. Chart #4 identifies the major asset classes in the portfolio and their performance over the past four years.

As noted in Chart #5, assets increased slightly despite a second year in a row of zero contributions. Fixed income continues to be the principal source of total return over the life of the Fund due to a combination of asset allocation and market forces. However, the Fund's equity investments have again provided a significant contribution to the Fund's performance for the most recent fiscal year. The asset allocation of the Fund at June 30, 2005, comprised 30.4% equities and 69.6% fixed income securities versus 26.7% equities and 73.3% fixed income securities, respectively, at June 30, 2004; thus the Fund's equity allocation continued to increase to a targeted approximately 70%-30% ratio in favor of fixed income securities. We continue to believe this overall asset risk allocation plan takes into consideration both the beneficiaries' long-term investment objectives and the distribution needs afforded by current income.

The Higher Education Endowment Trust Fund Act further provides that contributions shall include "… in any fiscal year in which a general fund surplus exists and the general fund stabilization reserve is funded to its required statutory level, funds raised by the estate tax under chapter 190 of Title 32 which are more than 125 percent of the amount projected by the emergency board in the July annual forecast made pursuant to section 305a of Title 32." This year a substantial contribution in the amount of $2,363,355.61 derives from fiscal year 2005, and this contribution became part of the Higher Education Trust Fund in July 2005. Thus the Fund's investment base is significantly increased for fiscal year 2006, and depending upon investment market conditions can be expected to generate additional returns to the Fund.

In summary, the investment performance of the Trust Investment Account again supported the distribution requirements of the Higher Education Trust Fund. Going forward, distributions will depend on the ongoing performance of the Fund, and will require continued monitoring of the Fund's investment performance.

Please feel free to contact me if you have any questions or concerns regarding this report.

cc: James Reardon, Commissioner of Finance & Management
Anne Winchester, Legislative Council

Appendix A
Higher Education Trust Fund
Quarterly Market Values

	Balance 9/30	Balance 12/31	Balance 3/31	Balance 6/30		
Education Trust						
FY2003	$7,885,377.45	$8,175,418.30	$8,212,332.41	$8,572,981.01		
FY2004	$8,242,399.79	$8,505,386.89	$8,697,470.84	$8,625,716.81		
FY2005	$8,241,108.63	$8,566,614.41	$8,617,473.66	$8,855,599.91		
Twelve Quarter Average	**$8,433,156.68**					
5% Distribution 2005	**$421,657.83**					
VSAC		$140,552.61			Contributions	
UVM		$140,552.61				
VSC		$140,552.61			Initial	$6,000,000.00
					2001	$1,000,000.00
2% FY2004	**$162,579.50**				2002	$635,881.49
UVM		$81,289.75			2003	$0.00
VSC		$81,289.75			2004	$0.00
Balance after Distributions	**$8,271,362.58**				Total	**$7,635,881.49**
2% FY2005	$168,663.13					
UVM		$84,331.57				
VSC		$84,331.57				

Appendix B
Trust Investment Account
Total Return Analysis

MANAGER	Fiscal Year 2001	Calendar Year 2001	Fiscal Year 2002	Calendar Year 2002	Fiscal Year 2003	Calendar Year 2003	Fiscal Year 2004	Quarter Ended 9/30/2004	Quarter Ended 12/31/2004	Calendar Year 2004	Quarter Ended 3/31/2005	Quarter Ended 6/30/2005	Fiscal Year 2005	Portfolio Market 6/30/2005	Portfolio Percent 6/30/2005
DOMESTIC EQUITY															
Hanson Investment Management	29.41%	17.41	(7.78)	(18.01)	-1.89%	42.55%	29.10%	-0.05%	13.77%	15.92%	3.00%	4.38%	22.25%	$7,073,222	16.2%
Prentiss Smith & Co.	7.59%	13.69	3.60	(7.35)	7.70%	18.17%	11.47%	-1.52%	11.61%	13.25%	0.07%	1.35%	11.00%	$6,162,361	14.2%
S&P 500	*-13.56%*	*-11.89%*	*-17.99%*	*-22.11%*	*0.25%*	*28.69%*	*19.14%*	*-1.87%*	*9.23%*	*10.90%*	*-2.15%*	*1.37%*	*6.32%*		*30.4%*
DOMESTIC FIXED INCOME															
NL Capital Management	10.34%	10.07%	9.41%	9.48%	8.92%	5.43%	3.48%	2.97%	1.14%	5.56%	0.22%	2.91%	7.42%	30,303,219	69.6%
Lehman Aggregate	*10.23%*	*8.44%*	*8.63%*	*10.25%*	*10.40%*	*4.10%*	*0.32%*	*3.20%*	*0.95%*	*4.34%*	*-0.48%*	*3.01%*	*6.80%*		
TOTAL FUND DOLLAR WEIGHTED RETURN	11.27%	11.62	7.94	5.15	8.59%	11.24%	7.59%	1.98%	4.31%	8.14%	0.62%	2.93%	10.17%		
Total Fund Target	7.52%	6.57	3.94	3.29	9.23%	9.94%	4.96%	1.86%	3.22%	6.23%	-0.96%	2.52%	6.76%		
TOTAL FUND MARKET VALUE ($mil.)	$25.6	$32.6	$33.3	$34.9	$37.3	$38.8	$39.3	$39.6	$41.1	$41.1	$41.3	$43.5	$43.5	$43,538,802	100.0%

* Inception date 7/15/00

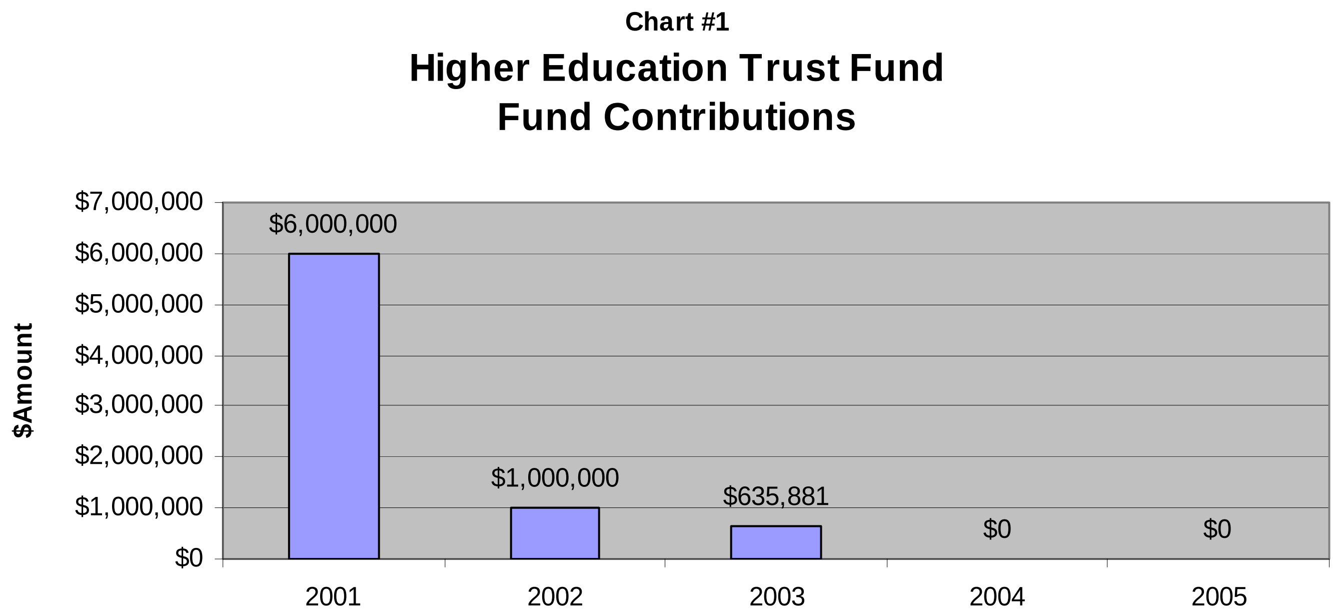


Chart #1
Higher Education Trust Fund
Fund Contributions
$Amount
$7,000,000
$6,000,000
$5,000,000
$4,000,000
$3,000,000
$2,000,000
$1,000,000
$0
$6,000,000
$1,000,000
$635,881
$0
$0
2001
2002
2003
2004
2005

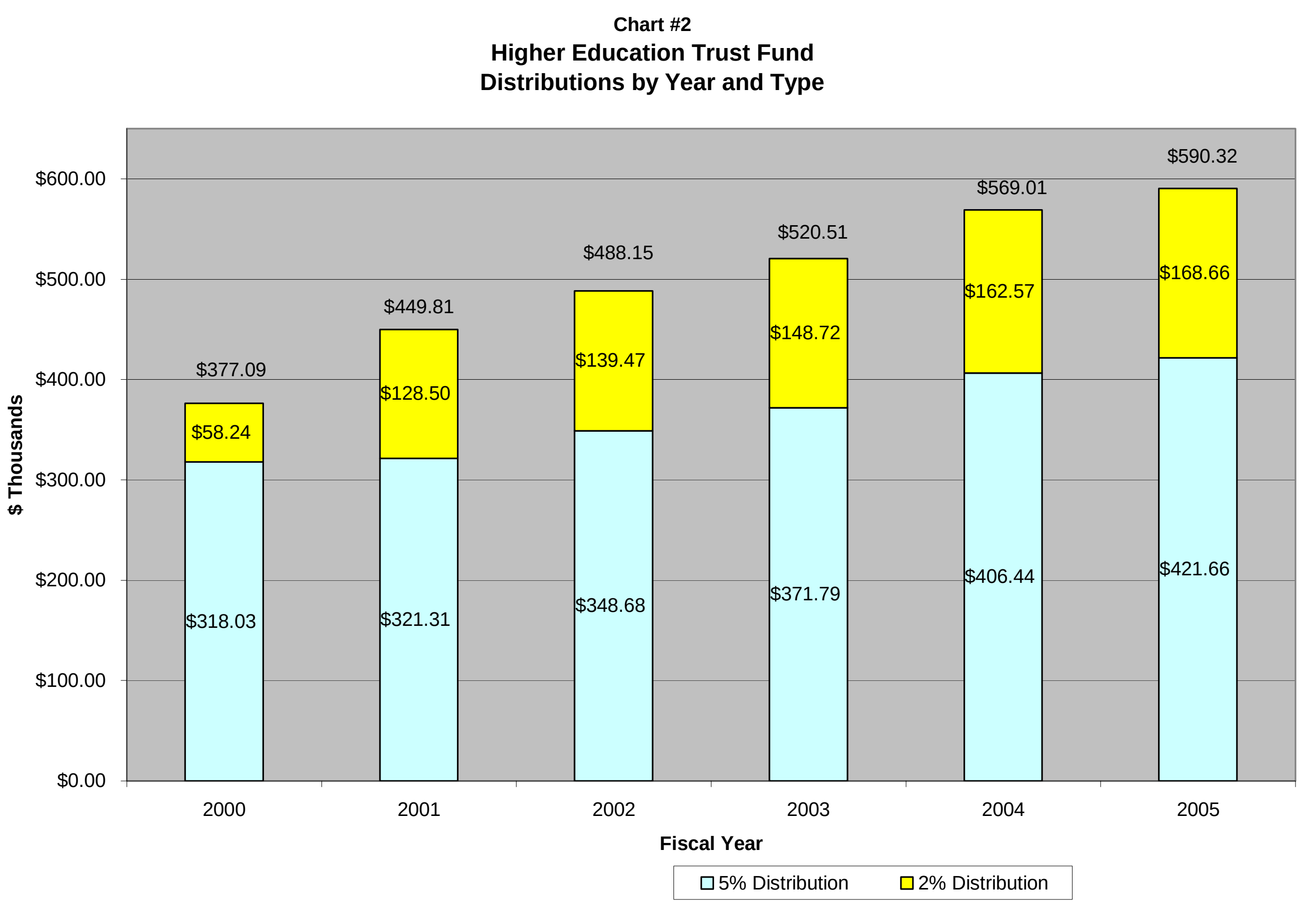


Chart #2
Higher Education Trust Fund
Distributions by Year and Type
$ Thousands
$600.00
$500.00
$400.00
$300.00
$200.00
$100.00
$0.00
$377.09
$58.24
$318.03
$449.81
$128.50
$321.31
$488.15
$139.47
$348.68
$520.51
$148.72
$371.79
$569.01
$162.57
$406.44
$590.32
$168.66
$421.66
2000
2001
2002
2003
2004
2005
Fiscal Year
5% Distribution
2% Distribution

Chart #3

Trust Investment Account Breakdown as of June 30, 2005

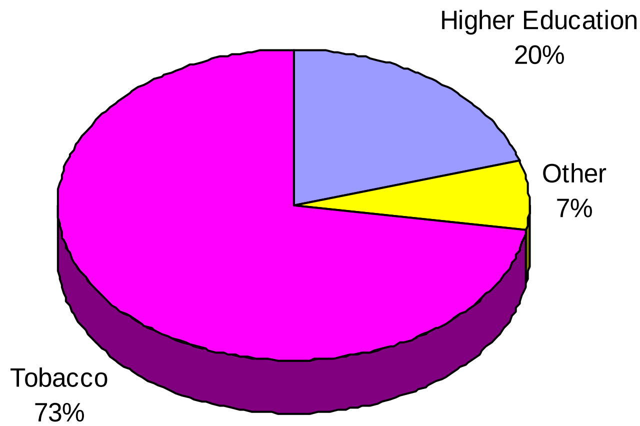
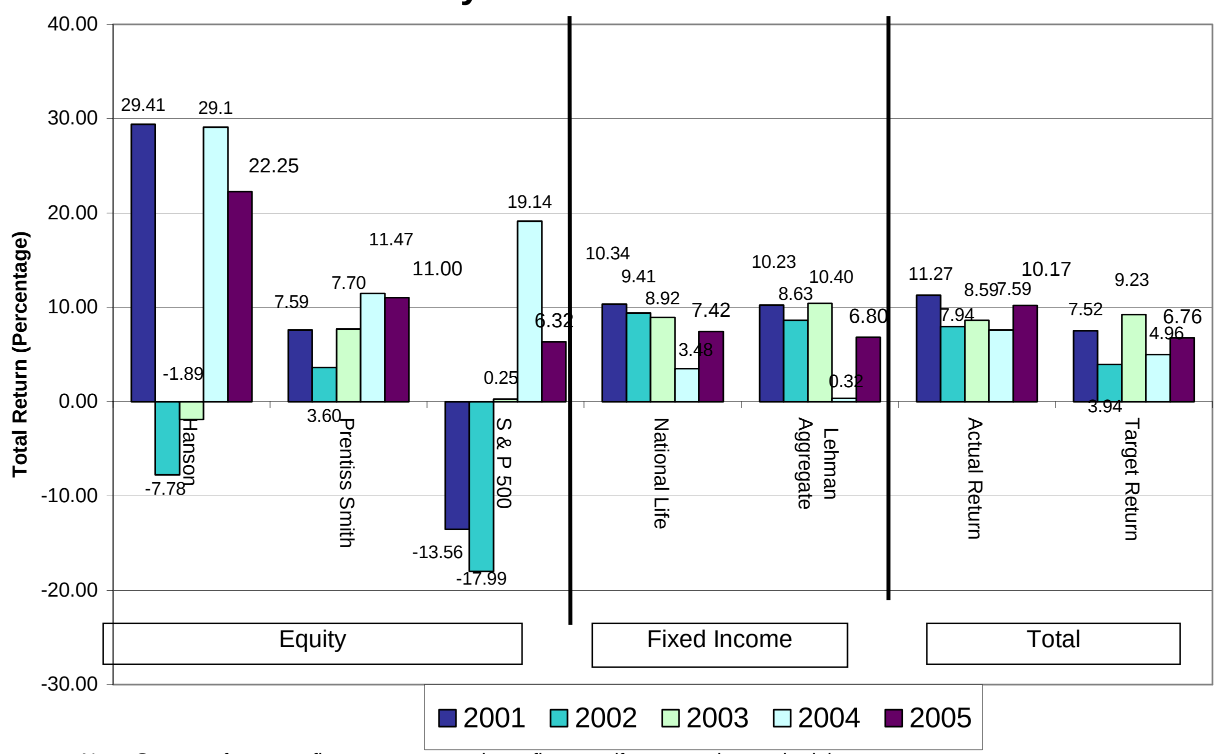


Chart #4

Higher Education Trust Fund
Total Return by Asset Class Fiscal Years 2001- 2005

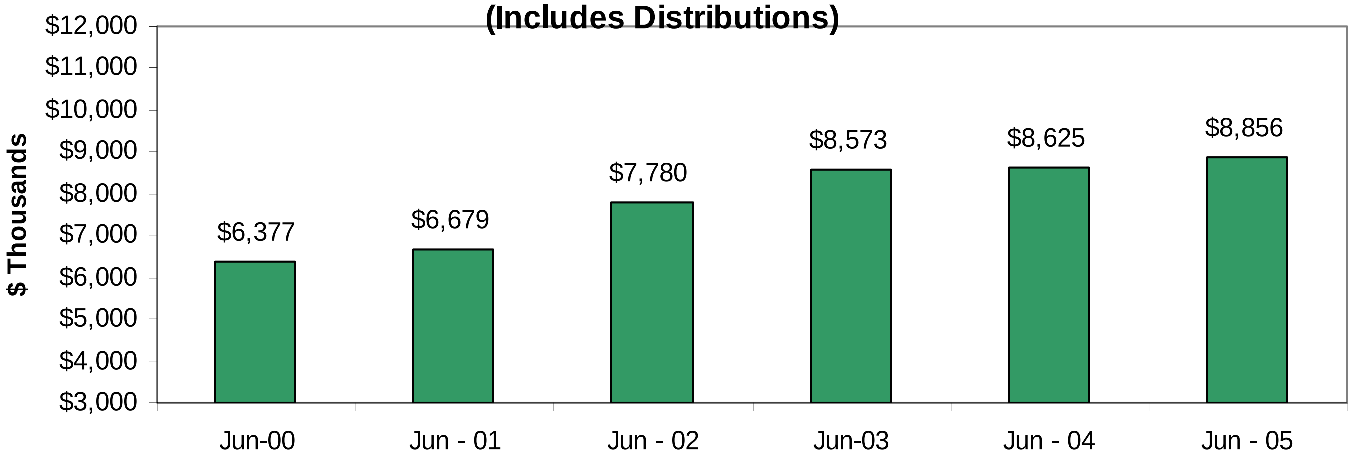


Note: Some performance figures are restated to reflect a uniform reporting methodology.

Chart #5

Higher Education Trust Fund

Asset Growth, 6/30/2000 to 6/30/2005



Report of the Commission on Funding the Vermont State Teachers' Retirement System

Executive Summary

Recommendations to the Governor
and the General Assembly

November 2005

"Because public pension benefits are legally inviolable, default is not an option. Sooner or later, taxpayers will be required to put up the money (or governments will be forced to borrow the money and tax a later generation to pay the interest)."

- Roger Lowenstein, "The End of Pensions," New York Times, October 30, 2005

Commission Membership

- Jeb Spaulding, State Treasurer and Chair of the Commission
- Senator James C. Condos of Chittenden County
- Senator Diane Snelling of Chittenden County
- Representative Kevin J. Endres of Milton
- Representative Anne H. Mook of Bennington
- John Simson, member appointed by the Governor
- James B. Reardon, Commissioner of Finance & Management
- Richard H. Cate, Commissioner of Education
- Joel D. Cook, Executive Director, Vermont National Education Association
- Mark Hage, Member Benefits Director, Vermont National Educational Association
- Michael Deweese, Superintendent, Chittenden Central Supervisory Union, representing the Vermont Superintendents' Association
- Joseph Mackey, Chair, Vermont State Teachers' Retirement System
- John A. Nelson, Executive Director, Vermont School Boards' Association

Executive Summary

The 2005 General Assembly created the Commission on Funding the Vermont State Teachers' Retirement System (VSTRS) to make recommendations for funding an adequate, sustainable, and actuarially sound retirement benefit plan for Vermont teachers to the Governor and the General Assembly by November 15, 2005.

The reason for the Commission is the fact that the VSTRS is underfunded and has been increasingly so for well over a decade. To address the serious resulting liability, the Commission makes a group of recommendations to be implemented together.

If these recommendations are adopted and implemented together, the State would cut the difference between this year's appropriated amount and what is required for FY 2007 by more than 60%, from a difference of almost $35 million to less than $13 million.

In order to make the implementation of those recommendations useful for state policy, however, the State will need to faithfully appropriate the actuarially required amount each year going forward. If a long-term commitment to funding is not achieved, then the result may be viewed as little more than putting additional "debt" on the State's credit card, with no real plan to pay.

The formal recommendations affect the way the appropriation for VSTRS is determined and stem from ideas brought forth by the VSTRS Board of Trustees, the Treasurer's Office and expert consultants. The Commission also considered a series of options for the State to consider for increasing its appropriation. While it did not consider its charge to include actually determining from what sources the state should seek the additional revenue needed, the Commission did consider a variety of funding options, and its conclusions are provided below.

The Commission offers this set of recommendations with optimism that by providing the means to bring the VSTRS appropriation level realistically within reach, the state will from now on make fully funding this important public pension program a strict priority to address each year.

The Commission here presents its key findings and recommendations.

Key Findings

- Chronic underfunding by the State, more conservative actuarial assumptions, and demographic trends have added considerably to the VSTRS' underfunded status, while greatly increasing the actuarially required annual contribution from the State.

- The actuarial methodology used by VSTRS under Vermont law is rarely used by other public pension plans. The unfunded liability calculated under this method does not reflect the actual experience of the plan, nor does it cause underfunding to be reflected in the "funded ratio" or "unfunded accrued liability," which are often used to measure and compare the financial health of pension plans.

- Using the actuarial methodology used by most states, the VSTRS funded ratio declined from 92.3% in 2001 to 81.1% in 2005.

- Using the actuarial methodology used by most states, the VSTRS unfunded liability increased from $93.8 million in 2001 to $315.1 million in 2005.

- For FY 2006, Vermont appropriated $24.4 million, less than half of the actuarially required contribution of $56.6 million.

- The problem of underfunding compounds itself. Underfunding in one year means lost investment returns in future years, resulting in ever larger required contributions, which will become increasingly difficult to reach.

- Relative to other public pension systems, the overall level of benefits for VSTRS is low or modest at best.

- Unless the State changes course soon, Vermont may not be able to catch up with actuarially required contributions without taking draconian measures, and may jeopardize its favorable credit rating.

- A new accounting standard adopted last year for all public retirement systems by the Government Accounting Standards Board, and effective in FY 2008, will require disclosure in financial statements of future funding liabilities for other post-employment benefits (OPEBs), primarily, health insurance for retirees, as well as accrual of costs for such benefits. For VSTRS, the additional initial annual expense to be recorded has been estimated at a $31 million annual obligation. This estimate was made under the assumption that the benefits will be pre-funded in an actuarially adequate manner; if not, the expenses will have to be computed using assumptions that will cause it to be substantially higher. The Vermont State Employees' Retirement System will be required to record an added estimated $25 million in annual expense for OPEB obligations under the new standard (assuming pre-funding). All public-sector retirement systems with OPEB obligations will be required to accrue such expenses.

Key Recommendations

- Make no change in benefits at this time because current benefits are modest by comparison with similar plans and because any realistic changes to the benefit structure would not provide significant immediate savings.

- Adopt the Entry Age Normal (EAN) actuarial methodology because doing so provides a more accurate picture of the plan's funded status and is consistent with most public retirement plans.

- Reamortize the unfunded actuarial liability (UAL) over 30 years because, while this will increase plan costs over that period, it will reduce the State's required annual contribution substantially.

- Increase the assumed rate of investment return by .25% because doing so reflects the beneficial effects of Vermont's new unified pension fund investment process.

- ➢ Create separate appropriations for normal and UAL costs because doing so will make plan costs associated with underfunding distinct from costs associated with paying benefits.

- ➢ Enact stronger statutory language to ensure that future appropriations match the actuarial recommendation.

- ➢ Fully fund both normal and UAL costs beginning in FY 2007 because doing so is necessary both to justify implementing other recommendations and to preserve the fiscal integrity of the VSTRS.

Potential Funding Options

Implementation of the Key Recommendations would reduce the actuary's formal recommendation for FY 2007 by $21 million (from $59.2 million to $38.2 million), shrinking the gap between the recommendation and the FY 2006 appropriation ($24.4 million) by more than 60%. A Medicare Part D reimbursement to the VSTRS, as discussed later in this report, will reduce the gap by another $1.2 million. The remaining gap of approximately $13 million is left to be filled by the Governor and the Legislature.

Closing that gap – and keeping it closed – is the critical element in achieving the goal of an adequate, sustainable, and actuarially sound retirement benefit plan for Vermont teachers.

To assist the Governor and Legislature in finding ways to close the gap, the Commission considered a range of funding options in more or less detail. The Commission gave its unanimous support to finding some of the funds needed through normal revenue growth in the general fund. Other options, discussed in greater detail in the body of this report, received either majority or minimal Commission support as set out below.

Majority support:

- Reallocation of existing resources in the budget to fund the actuarially required contribution.

- One-time reduction of the general fund transfer to the education fund, in order to increase the base appropriation for the VSTRS pension obligation.

- Increase in personal income or other tax sources.

Minimal support:

- Fund all or part of the need through the Education Fund.
- Increase employee contributions for future normal costs.
- Require local school districts to share the costs of future pension liabilities with the State.
- Phase-in increases over a defined period, if necessary.
- Sell selected state assets.